



Lex Mercatoria in International Arbitration Theory and Practice

Volume II

Mert Elcin

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c. Several Instances of Substantive Application

In the order of international commerce, the contracting parties articulate their knowledge of the particular circumstances of time and place through the contractual clauses and their choice of default rules. The decision maker applying *lex mercatoria* utilizes those articulated rules through the cooperation of the parties on the basis of the basic principles of freedom of contract and *pacta sunt servanda*, and procedural safeguards. To the extent that those rules require *ex post* interpretation, supplementation or intervention, the decision maker discovers established rules in the particular case through a technique of thought, which materializes with new constellations of circumstances within the substantive framework provided by the principle of good faith and fair dealing under *lex mercatoria*. The decision maker exercises an abstract reasoning in the specialized consolidations to find those established rules, without being bound by the formal consolidations under the national legal systems, unless they are incorporated by the parties into the articulated rules through a choice of law clause, or they indicate the reasonable expectations of the parties in a particular case pursuant to the established rules of conflict, in such areas of law where the approaches of national legal systems diverge significantly.

While the materials subject to the specialized consolidations of the decision maker vary from case to case, the element of abstract reasoning in the specialized consolidations should always follow the abstract relations constituting the spontaneous order of international commerce in order to maximize the possibility of expectations of the elements of the order being fulfilled, matched and not conflicting. The decision maker, by following such abstract relations, should mentally reconstruct the tacit aspect of the knowledge of circumstances of time and place possessed by the parties, in order to control legal uncertainty arising from the articulated rules and to allocate the residual contractual rights, obligations and risks in accordance with their reasonable expectations. The importance of such abstract relations arises from the nature of the order of international commerce. The order of international commerce does not manifest itself to the contracting parties' senses as a national legal order, but as the abstract relations within this spontaneous order. The decision maker applying *lex mercatoria* should act on the consideration that the success of parties' actions in achieving their aims in the order of international commerce depends on their capacity to adapt their actions both to the particular facts which he knows and to other facts they do not or cannot know. Thus, the decision maker applying *lex mercatoria* should assume that the individuals are aware of the existence of this spontaneous order which, not having been made, does not have a particular purpose, as a necessary condition for the successful pursuit of their purposes. By this means, under *lex mercatoria*, the tacit knowledge of this order is brought to bear on the allocational *ex post* decision with regard to the residual contractual rights, obligations and risks.

It is possible to identify three sources for abstractions that should motivate the reasoning of the decision maker in reconstructing the tacit knowledge of the parties and in applying to the substance of the dispute whatever rules or standards of contractual, national or transnational origin. These sources are national contract laws, international instruments relating to international commercial contracts, and contracting practices in the order of international commerce. The abstractions from these sources usually, but not necessarily, indicate the established rules in the order of international commerce. Even if the decision maker cannot articulate an established rule in the order of international commerce through such abstractions, the abstract reasoning is still important since it constitutes the background for the decision making on the basis of the application of *lex mercatoria* to the substance of the dispute either as *lex fori* or *lex contractus*. Thus, the abstractions need not be articulated by the decision

maker in the final award in each instance, but it should form the basis of specialized consolidations and the decision making under *lex mercatoria*.

The first source of abstractions is the contract laws of the national legal systems, as the elements of the order of international commerce. In a particular case, the decision maker may focus on a certain group of national laws that are connected to the dispute in his specialized consolidations. However, as far as the element of abstract reasoning in the specialized consolidations is concerned, the decision maker applying *lex mercatoria* should consider the approaches of civil and common law of contract, since those two legal traditions have influenced profoundly and decisively the other sources of abstractions. In this regard, the dissertation focuses particularly on German and French laws as examples of civil legal systems, and English and US laws, as examples of common legal systems.

The second source is the international instruments relating to international commercial contracts. The relevant international instruments in a particular case may vary significantly in each particular case. Even so, the CISG, as an instrument of deliberate balancing among the approaches of the civil and common law of contract, has been the most widely accepted convention regulating contracts in the order of international commerce.¹⁵⁸⁵ Although its sphere of application is limited to international sale of goods, the decision maker applying *lex mercatoria* may consider its individual provisions as indicating the established rules of contract at an abstract level, in view of the consideration that the contract of sale is the backbone of international markets and the order of international commerce, and due to the participation of a wide range of the elements of the order of international commerce in its preparation.¹⁵⁸⁶ The CISG has also influenced the abstract reasoning of the drafters of the international restatements of contract principles in their specialized consolidations to set forth “general rules for international commercial contracts” under UNIDROIT Principles or “general rules of contract law in the European Union” under the PECL. Thus, in the dissertation, the abstractions from the CISG, the UNIDROIT Principles and the PECL are considered as a factor that should determine the reasoning of the decision maker applying *lex mercatoria*.

Finally, the international contracting practices should motivate, at an abstract level, the reasoning of the decision maker applying *lex mercatoria*. The abstractions of the decision maker in this regard may depend on his own experience in the order of international commerce, or the parties’ evidence of such practices. Such abstractions should not be treated as trade usages in the narrow or broad sense, but as indicating the abstract understanding or preferences of the drafters of international contracts. Although, in the order of international commerce, the contracting practices may diverge widely, depending on the type of contract,

¹⁵⁸⁵ As of 24 February 2012, the UNCITRAL reports that 78 States have adopted the CISG. http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html

¹⁵⁸⁶ At the United Nations Diplomatic Conference which adopted the CISG, “62 states took part: 22 European and other developed Western states, 11 socialist, 11 South-American, 7 African and 11 Asian countries; in other words, roughly speaking, 22 Western, 11 socialist and 29 third world countries”. Eörsi, Gyula, A Propos the 1980 Vienna Convention on Contracts for the International Sale of Goods, *American Journal of Comparative Law*, 31 (1983), at 335; The Conference also relied on the comments and proposals of the following international organizations: the Central Office for International Railroad Transport in Bern, the World Intellectual Property Organization (WIPO), the International Chamber of Commerce, the Asian African Legal Consultative Committee, and the Council for Mutual Economic Assistance (COMECON), along with an analysis of these comments and suggestions by the UN Secretariat. Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 20-21

the bargaining power and strategies adopted by the parties during the negotiations, the decision maker applying *lex mercatoria* may still act on such abstractions that partly explain the mechanisms of contractual allocation of rights, obligations and risks in various situations, and reasons for recurrence of the certain types of clauses in contracting practices. In this regard, the dissertation concentrates on four specific types of model contracts provided by international organizations, which can be considered as reflecting the international contracting practices at an abstract level, and the characteristics of the transactions governed through legal uncertainty, due to their complex, innovative or long term nature. These are Fédération Internationale des Ingénieurs-Conseils (International Federation of Consulting Engineers, FIDIC) Conditions of Contract for Construction¹⁵⁸⁷, the ICC Model Mergers & Acquisitions Contract, Share Purchase Agreement¹⁵⁸⁸, the ICC Model Contract for the Turnkey Supply of an Industrial Plant¹⁵⁸⁹, and the ICC Model Commercial Agency Contract.¹⁵⁹⁰ These contracts essentially the product of the abstract reasoning of their drafters articulating such contract terms that provides a balanced framework, which facilitates and shortens the negotiating process.

The FIDIC Conditions were first published in 1957, and based on the English Institution of Civil Engineers (ICE) Conditions. In subsequent editions, the FIDIC Conditions have become progressively more “international” in style and content, while retaining a common law orientation.¹⁵⁹¹ The FIDIC Conditions reflects the characteristics of the transactions governed through legal uncertainty, since the complexity and length of international construction projects and the numerous risks involved potentially give rise to many questions of allocation of rights, obligations and risks. The FIDIC Conditions are the best known and probably most widely used international standard form of construction contract conditions.¹⁵⁹² A number of the multilateral development banks have adopted the FIDIC Conditions as part of their standard bidding documents that they required their borrowers or aid beneficiaries to follow. During 2005, FIDIC licensed Multilateral Development Banks (MDB) to use a revised version of the Conditions of Contract for Construction. This is known as the MDB Harmonized Edition 2005, and is referred to in the dissertation as the FIDIC Conditions.¹⁵⁹³ The MDB Edition is only used for contracts that are financed by one of the participating banks.¹⁵⁹⁴ The MDB Edition includes a number of changes to the 1999 Red Book. Some of these changes incorporate Clauses from previous MDB Contracts and the intention is to

¹⁵⁸⁷ Conditions of Contract for Construction for Building and Engineering Works Designed by the Employer, 1st Ed. (1999 Red Book)

¹⁵⁸⁸ ICC Publication No. 656, 2004

¹⁵⁸⁹ ICC Publication No. 653, 2003

¹⁵⁹⁰ 2nd ed., ICC Publication No. 644, 2002

¹⁵⁹¹ Seppälä, Christopher R., *International Construction Contract Disputes: Commentary on ICC Awards Dealing with the FIDIC International Conditions of Contract*, *International Business Law Journal*, (1999), at 700

¹⁵⁹² Seppälä, Christopher R., *International Construction Contract Disputes: Second Commentary on ICC Awards Dealing Primarily with FIDIC Contracts*, *ICC International Court of Arbitration Bulletin*, 19-2 (2008), at 41

¹⁵⁹³ The MDB Harmonized Edition is first published in May 2005 and then revised in March 2006 and June 2010.

¹⁵⁹⁴ These are African Development Bank, Asian Development Bank, Black Sea Trade and Development Bank, Caribbean Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank, International Bank for Reconstruction and Development (The World Bank), Islamic Bank for Development Bank and Nordic Development Fund.

standardize and reduce the need for further Particular Conditions.¹⁵⁹⁵ It is argued that what was already the leading set of international construction contract conditions, has also become the rule for the major construction projects supported by the world's leading development financing institutions, and it is now much more than a device developed over time by parties to construction contracts.¹⁵⁹⁶

The ICC Model Mergers & Acquisitions Contract, Share Purchase Agreement, is prepared to assist parties and lawyers who are not specialized in the field of mergers and acquisition contracts to draft a simple contract covering the most common issues involved.¹⁵⁹⁷ The complex nature of such contracts arises from the fact that the subject of the contract is the transfer of an enterprise, in particular when it takes place cross border.¹⁵⁹⁸ Moreover, the steps leading up to the conclusion and performance of a share purchase agreement constitutes a considerably long process. In cross-border share purchase agreements, reliance on national rules governing sales is not recommended as national laws are considered to be far too unspecific for these deals. The CISG does not apply to share deals (Article 2(d)), and asset deals are only covered if more than 50 per cent of the value of the assets consist in goods within the meaning of the CISG. Thus, the parties to such transactions almost always use their freedom of contract in order to agree on specifically negotiated transaction terms.¹⁵⁹⁹ On the other hand, the structure and contents of those transactions are strongly influenced by the models and forms developed within common law jurisdictions, which has caused the parties to use clauses and concepts which belong to the common law systems, independently from the law governing the contract.¹⁶⁰⁰

The ICC Model Contract for the Turnkey Supply of an Industrial Plant covers the contract for the supply of a complete plant or production line to be erected within facilities of the purchaser, where the supplier's main obligation is to supply the equipment and to assist the purchaser during erection and start up. It is mainly a form of contract for the sale of equipment, with accessory obligations regarding erection, start up, training of personnel, etc. Thus, turnkey contract for a plant can be regarded as a contract for sale, which may be governed by the rules on sale contracts, and the CISG, although with peculiar characteristics, which are closer to a construction contract. The turnkey supply of a plant is a complex operation which entails a number of stages, which vary from contract to contract. The Task Force preparing the ICC Model Contract, in view of the difficulties to find common solutions that can be used for all contracts of the same type, tried to work out a flexible model that

¹⁵⁹⁵ For the review of the changes see Totterdill, B.W., *FIDIC Users' Guide: A Practical Guide to the 1999 Red and Yellow Books: Incorporating Changes and Additions to the 2005 MDB Harmonised Edition*, ICE Publishing; Rev. ed., 2006, at 355 et seq.

¹⁵⁹⁶ Molineaux, Charles, *Moving Toward a Lex Mercatoria - A Lex Constructionis*, *Journal of International Arbitration*, 14-1 (1997), at 59

¹⁵⁹⁷ ICC Model Mergers & Acquisitions Contract, International Chamber of Commerce, ICC publication, 656, Paris, 2004, at 7

¹⁵⁹⁸ Ehle, B. D., *Arbitration as a Disputes Resolution Mechanism in Mergers and Acquisitions*, *Comparative Law Yearbook of International Business*, (2005), at 287

¹⁵⁹⁹ Peter, Wolfgang, *Arbitration of Mergers and Acquisitions: Purchase Price Adjustment Disputes*, *Arbitration International*, 19-4 (2003), at 492

¹⁶⁰⁰ ICC Model Mergers & Acquisitions Contract, International Chamber of Commerce, ICC publication, 656, Paris, 2004, at 7

gives a general overview of the most common way of these contracts are carried out while taking into account the need for differentiation.¹⁶⁰¹

The ICC Model Commercial Agency Contract is drafted to cover the long-term agency relations in the scope of international commerce and more particularly in a European context.¹⁶⁰² The Working Party aimed at putting at the disposal of parties engaged in international commerce a contract that can be used generally, without the need to adapt it to a specific national legislation and basing the model contract on neutral ground, detached from specific national legislations, while at the same time incorporating prevailing international standards as well as rules generally accepted in national legislations.¹⁶⁰³

In the dissertation, the arbitral awards are examined in the background of these sources of abstractions that should determine the reasoning of the decision maker applying *lex mercatoria*. Where possible and relevant, the arbitral awards and dissenting opinions are cited extensively in order to demonstrate to what extent the approaches of the arbitrators reflect the abstract reasoning and the principled decision making set forth by this theory of *lex mercatoria* in relation to some selected issues that concern the substance of the disputes arising from international contracts. The analysis of arbitral awards in this background also seeks the signs of the impression of splitting the difference and puts forward some possible explanations for such an impression in the context of those selected substantive issues. The selected instances of substantive application of *lex mercatoria* include; (i) duty of cooperation, (ii) duty to achieve a specific result and duty of best effort, (iii) force majeure, (iv) hardship, (v) right to terminate the contract, and (vi) damages for non-performance.

¹⁶⁰¹ ICC Model Contract for the Turnkey Supply of an Industrial Plant, ICC publication, 653, Paris, 2003, at 10-13

¹⁶⁰² Bortolotti, Fabio, Towards a New *Lex Mercatoria* regarding International Commercial Agency: The ICC Model Commercial Agency Contract, *International Business Law Journal*, (1995), at 685

¹⁶⁰³ Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract, A Commentary*, ICC Publication No. 512, Paris, 1993, at 1

i. Duty of Cooperation

In the order of international commerce, the knowledge of the particular circumstances of time and place potentially puts every individual in an advantageous position over all others in that he possesses unique knowledge. The individuals enter into contracts to utilize such knowledge in achieving their various purposes in the spontaneous order of international commerce, which enables them to make feasible plans. However, once the individual enters into a contract, there appears the possibility of conflict between the interests of the individual and the interests of both parties in their contractual relationship. This is because once the rights, obligations and risks are specifically allocated through the rules that are articulated by the parties, each party has less incentive to bear the costs of accommodating the other's subsequent request for adjustments in the initial allocation, and each party thus confronts the question of whether to act cooperatively or to respond to immediate self-interest and evade the responsibility.¹⁶⁰⁴

The articulated rules should encourage both parties to undertake active or passive cooperative actions. Those actions can be in the form of an active conduct, such as duties of notification or negotiation, or a passive conduct, in the sense of refraining from performing particular acts that can be detrimental in achieving the contractual purpose, such as duties of non-competition. However, the transaction, to which *lex mercatoria* is applicable, is inherently incomplete. When parties enter into such a transaction, certain aspects of which are governed through legal uncertainty, frequently there will be questions of residual contractual obligations arising from the unspecified instances of cooperation for the successful performance of contractual obligations or for achieving the purpose of the contract, or the closer confidence generated between the parties throughout the contractual relationship.

1. Sources of Abstractions

a. National Laws

It is argued that the duty of cooperation represents an emerging general principle of law.¹⁶⁰⁵ However, the civil and common law systems have contrasting views as to the duties of cooperation between the contracting parties. The civil law systems attach a strong role for the duty to cooperate on the basis of the principle of good faith. Under German law, the duty to cooperate is one of the ancillary duties that are read into a contract on the basis of Section 242 of the German Civil Code, which provides that the contracting parties must perform their obligations in accordance with good faith in light of common practice. Ancillary duties are additional duties that are not directly related to the performance of the primary obligations. They can be either in the form of application of judge-made law or they can be supplemented to the contract from specific provisions of the Civil Code.¹⁶⁰⁶

¹⁶⁰⁴ Scott, Robert E., *Conflict and Cooperation in Long-Term Contracts*, California Law Review, 75-6 (Dec., 1987), at 2008

¹⁶⁰⁵ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 542; Bonell, Michael Joachim, *An International Restatement of Contract Law: the UNIDROIT Principles of International Commercial Contracts*, Transnational Publishers, 3rd ed., 2005, at 146

¹⁶⁰⁶ Kornet, Nicole, *Contract Interpretation and Gap Filling: Comparative and Theoretical Perspectives*, Intersentia, 2006, at 118

The principle of good faith under Section 242 of the German Civil Code provides the basis for various, independently enforceable duties to cooperate with respect to the performance of the contract, whenever one party's duty to perform cannot be realized without the cooperation of the contracting partner. For instance, if the validity or feasibility of a contract depends on a public permission being obtained, there is a duty for both parties to cooperate with respect to the application for the permission and to refrain from doing something that could jeopardize the permission being granted. The parties are also under a duty to cooperate to adapt the contract if this is required by the public permission. Similarly, the parties are under a duty to cooperate to adapt the contract in the case of changed circumstances. The boundaries of the contractual duty to cooperate are usually defined by the criterion of the reasonableness for the party who must perform the duty. Reasonableness is determined on the basis of the contractual purpose and the interests of the other party.¹⁶⁰⁷

Under French law, Article 1134 (3) of the Civil Code provides that contracts must be performed in good faith. Although the traditional approach to this provision was that good faith required merely that one keep to one's agreements and that they be interpreted according to the parties' true intentions rather than the words which they used, the good faith has gradually acquired a greater significance and practical importance in the modern law.¹⁶⁰⁸ It has become generally accepted in French law that good faith in performance has acquired two particular expressions in the case law: a "duty of loyalty", which sanctions bad faith in the sense that a party to a contract deprives the other of the intended benefit of performance of the contract, and a "duty of cooperation", which ensures the greatest effectiveness a contract to the benefit of both parties according to its nature.¹⁶⁰⁹ However, both the notion of good faith and its use in those particular expressions by the courts remain contested in French law. Some consider Article 1134 (3) as a technical provision, possessing no significance of substance, and even useless, given that Article 1135 requires the courts to supplement the parties' agreement with legal, customary and equitable obligations, and they contend that the attempts to give it a more substantial significance threatens the legal certainty. On the other hand, there are others, who emphasized the cooperative nature of contracts, according to which the contractors form a sort of microcosm and the contract is a sort of partnership where each must work towards a common purpose which is the sum (or more) of individual purposes pursued by each. Thus, the majority of the French doctrine holds more moderate positions.¹⁶¹⁰ It is admitted that the contracts often appear as the result of a tension between antagonistic interests and the striking of a balance between divergent interests, so that the duty of good faith does not oblige a person to protect the interests of another person to the detriment of his own interest.¹⁶¹¹

The US legal system is not at odds with the implication of duty to cooperate in contract, since the duty to cooperate is linked to the overarching duty of good faith and fair dealing and, thus,

¹⁶⁰⁷ Ibid., at 127-128; Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 121

¹⁶⁰⁸ Bell, John, Sophie Boyron & Simon Whittaker, *Principles of French law*, Oxford University Press, 2nd ed., 2008, at 332-333

¹⁶⁰⁹ Whittaker, Simon & Reinhard Zimmermann, *Good faith in European Contract Law: Surveying the Legal Landscape*, in Reinhard Zimmermann and Simon Whittaker (eds.), *Good faith in European Contract Law*, Cambridge University Press, 2000, at 37

¹⁶¹⁰ Ibid., at 38

¹⁶¹¹ Bell, John, Sophie Boyron & Simon Whittaker, *Principles of French law*, Oxford University Press, 2nd ed., 2008, at 333-334

it can be applied as a term implied in law, one imposing an obligation of good faith.¹⁶¹² The obligation of good faith and fair dealing, which exists in all contracts, requires in some cases only absence of interference in the other party's performance, but in others, affirmative conduct to cooperate in enhancing the other party's interests under the contract.¹⁶¹³ On the other hand, English law does not require the attention of a party to the interests of other, which amounts to absolute "good faith", and the courts have traditionally been much more reluctant to impose a duty of cooperation on the parties to commercial contracts.¹⁶¹⁴ Under English law, the duty to cooperate can be read into the contract as a term implied in fact. For instance, a term of this sort was implied as a relatively limited obligation to either secure reasonably safe conditions or to warn the other party if such conditions are not provided, where this is necessary in order to give "business efficacy to the contract" on the basis of the presumed intentions of the parties.¹⁶¹⁵ English law imposes an implied duty to cooperate where this is necessary in order to give business efficacy to the agreement since, without it, the purpose of the contract would be defeated. While "necessity" is the prime factor to be taken into account, English law does not demand cooperation merely because that would be reasonable.¹⁶¹⁶ The English courts refused to give the duty to cooperate the status of a rule of law. Each contract must be looked at and considered in itself.¹⁶¹⁷ Thus, the question is one of whether a term can be implied in fact, which depends on the "intentions of the parties" in that case.¹⁶¹⁸

The reason for the reluctance of the English law is probably the consideration that the duty to cooperate, as a rule of law, implies an approach which regards contracts as "common projects"¹⁶¹⁹ of the parties, so it is deemed at odds with the paradigm of market-individualism under the traditional English contract law, which regards contracting as self-interested dealing.¹⁶²⁰ It is argued that as the traditional model of dealings has been gradually replaced,

¹⁶¹² Patterson, Edwin W., *Constructive Conditions in Contracts*, Columbia Law Review, 42 (1942), at 928-942; Summers, Robert S., "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, Virginia Law Review, 54 (1968), at 241; Summers, Robert S., *The Conceptualization of Good Faith in American Contract Law: A General Account*, in Reinhard Zimmermann & Simon Whittaker (eds.) *Good faith in European contract law*, Cambridge University Press, 2000, at 124

¹⁶¹³ Hadjiyannakis, Helen, *The Parol Evidence Rule and Implied Terms: The Sounds of Silence*, Fordham Law Review, 54 (1985), at 35-36

¹⁶¹⁴ The strongest recognition has been in relation to contracts of employment; see *Secretary of State for Employment v. ASLEF (No.2)* [1972] 2 Q. B. 455 (C.A.); Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 121

¹⁶¹⁵ *The Moorcock* (1889) 14 P.D. 64 (C.A.)

¹⁶¹⁶ Burrows, J. F., *Contractual Co-operation and the Implied Term*, Modern Law Review, 31 (1968), at 404

¹⁶¹⁷ *Mona Oil Equipment Co. v. Rhodesia Railways Ltd.* [1949] 2 All E.R. 1018, Devlin J.: "I can think of no term that can properly be implied other than one based on the necessity for co-operation. It is, no doubt, true that every business contract depends for its smooth working on co-operation, but in the ordinary business contract, and apart, of course, from express terms, the law can enforce co-operation only in a limited degree-to the extent that is necessary to make the contract workable. For any higher degree of co-operation the parties must rely on the desire that both of them usually have that the business should get done."

¹⁶¹⁸ Burrows, J. F., *Contractual Co-operation and the Implied Term*, Modern Law Review, 31 (1968), at 406

¹⁶¹⁹ Official Comment to Article 5.1.3 of the UNIDROIT Principles; see also UNIDROIT 1987 – Study L – Doc. 39, Rome, April 1987 at 8

¹⁶²⁰ Brownsword, Roger, *Contract Law, Co-operation, and Good Faith: the Movement from Static to Dynamic Market Individualism*, in Simon Deakin and Jonathan Michie (eds.) *Contracts, Co-operation, and Competition: Studies in Economics, Management, and Law*, Oxford University Press, 1997, at 262

in practice, by a model of cooperative dealing, which is characterized by values of trust and continuity, English law has gradually recognized that contract law can also perform other functions such as fostering cooperation and preventing opportunistic behavior. However, contract law is still predominantly seen as a risk allocation device and, those other functions are seen as ancillary.¹⁶²¹ Thus, the duty to cooperate under English law could not achieved the status of an implied term in law, and its application is limited to its possible implication in the contract as an implied term in fact in a particular case.

b. International Instruments

It is argued that a general duty of the parties to cooperate can possibly be derived from the CISG as one of the underlying principles pursuant to Article 7.¹⁶²² While the CISG does not contain a general provision, it envisages several specific instances of cooperation between buyer and seller. The duty of cooperation can be deduced from the duties provided in the CISG, such as the duty to preserve goods to be returned according to Articles 85 and 86, the duty to accept cure according to Articles 34, 37 and 48, the duty to mitigate the loss resulting from the breach under Article 77. These duties as well as Article 32 on shipping arrangements¹⁶²³, Article 54 on the payment of the price¹⁶²⁴ and Article 60 on buyer's obligation to take delivery¹⁶²⁵ can be interpreted to express the general principle that every party is obliged to enable the other party to perform and not to jeopardize the contractual purpose.

Article 5.1.3 of the UNIDROIT Principles explicitly provides that each party shall cooperate with the other party when such cooperation may reasonably be expected for the performance of that party's obligations. In the Official Comment, it is stated that a contract is not merely a meeting point for conflicting interests but must also, to a certain extent, be viewed as a "common project" in which each party must cooperate.¹⁶²⁶ The Official Comment clearly relates the duty to cooperate to the principle of good faith and fair dealing under Article 1.7.

¹⁶²¹ Cafaggi, Fabrizio, *Creditor's Fault: In Search of a Comparative Frame*, EUI Working Papers Law No. 2009/15, available at <http://ssrn.com/abstract=1551825>, at 11

¹⁶²² Ferrari, Franco, *Uniform Interpretation of the 1980 Uniform Sales Law*, *Georgia Journal of International and Comparative Law*, 24 (1994), at 226 referring to "the principle according to which the parties must provide the cooperation needed "in carrying out the interlocking steps of an international sales transaction"; Bonell, Michael Joachim, Article 7, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 81 referring to "the rule according to which each party is bound to cooperate with the other to the extent that such cooperation is necessary in order to enable that other party to properly perform his contractual obligations" Enderlein, Fritz & Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary*, Oceana Publications, 1992, at 60: "The obligation of the parties to co-operate in performing the contract, in particular in the case of disturbances, with the aim of minimizing the effect of such disturbances on the party who caused it or at whose place it occurred, can be synthesized from a number of articles."

¹⁶²³ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 246: "Paragraph (3) articulates a duty of cooperation that, in most cases, probably could be established as an aspect of applicable usages or practices."

¹⁶²⁴ *Ibid.*, at 350: "The Convention at many points responds to the fact that consummating an international sale calls for cooperation; each party must take steps that are related to corresponding steps by the other."

¹⁶²⁵ *Ibid.*, at 373: "Paragraph (a) provides yet another instance of the Convention's recognition of the importance of cooperation in carrying out the interlocking steps of an international sales transaction."

¹⁶²⁶ Official Comment to Article 5.1.3 of the UNIDROIT Principles

The breach of the duty of cooperation constitutes non-performance since, according to Article 7.1.1, non-performance is defined as the failure by a party to perform any of its obligations under the contract. As a consequence, the aggrieved party can invoke any of the remedies available under Chapter 7 of the UNIDROIT Principles if their specific requirements are met.

The duty of cooperation under the UNIDROIT Principles has two dimensions, as the instances of active or passive cooperation.¹⁶²⁷ First, each party is under a duty to remain passive if a particular action might hinder the performance of the other party. For example, the duty of cooperation is violated if a party buys all available goods of a certain kind, thereby depriving the other party of its ability to perform its obligation to supply the first party with these goods.¹⁶²⁸ The second dimension of the duty to cooperate provides that each party is under a duty to engage in actions if such actions are required to enable or facilitate the other party's performance. The Official Comment to Article 5.1.3 provides two examples: the duty to mitigate harm in the event of non-performance of the other party (Article 7.4.8) and the duty to assist the other party in obtaining a public permission (Articles 6.1.14-6.1.17).¹⁶²⁹

There are also references to Article 5.1.3 in the comments of other provisions of the UNIDROIT Principles. Article 5.1.3 applies if a party that is aggrieved by non-performance receives effective notice of cure from the non-performing party under Article 7.1.4, and requires the aggrieved party to permit any inspection that is reasonably necessary for the non-performing party to effect cure.¹⁶³⁰ Article 5.1.3 also requires that the assignor of a right is obliged to take all the steps necessary to permit the assignee to enjoy the benefit of accessory rights and securities that are transferred to the assignee under Article 9.1.14.¹⁶³¹ In addition, the duty of cooperation requires a party to inform the other party of a move of its place of business subsequent to the conclusion of the contract, as provided in the Official Comments to Article 6.1.6 regarding place of performance.¹⁶³² According to the Official Comments to Article 6.2.3 on the effects of hardship, the duty to cooperate requires that the request for renegotiations by the disadvantaged party and the conduct of both parties during the renegotiation process should be carried out in a constructive manner, in particular by refraining from any form of obstruction and by providing all the necessary information.¹⁶³³

The Official Comment to Article 5.1.3 provides that the duty of cooperation must have certain limits, which should be based on the reference to reasonable expectations, so as not to upset the allocation of duties in the performance of the contract. Thus, the duty to cooperate only exists to the extent that "co-operation may reasonably be expected". An early draft of Article 5.1.3 suggested the imposition of duty to cooperate with the other party whenever "such cooperation is necessary for the performance of that party's obligations", similar to the English approach to contractual cooperation as an implied term in fact.¹⁶³⁴ The Working

¹⁶²⁷ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 543

¹⁶²⁸ See Illustration 1 to Article 5.1.3 of the UNIDROIT Principles

¹⁶²⁹ See Illustration 2 to Article 5.1.3 of the UNIDROIT Principles although the comment of Article 5.1.3 does not specifically refer to Article 6.1.14.

¹⁶³⁰ Official Comment 10 to Article 7.1.4 of the UNIDROIT Principles

¹⁶³¹ Official Comment 4 to Article 9.1.14 of the UNIDROIT Principles

¹⁶³² Official Comment 3 to Article 6.1.6 of the UNIDROIT Principles

¹⁶³³ Official Comment 5 to Article 6.2.3 of the UNIDROIT Principles

¹⁶³⁴ UNIDROIT 1985 – Study L – Doc. 34, Rome, October 1985, draft Article 1(2)

Group questioned the appropriateness of the “necessity” criterion, which limits the duty of cooperation only to those cases where such cooperation was necessary for the performance of the other party’s obligation, and concluded that the formula could be construed in the sense that what is ultimately required by a party is not to hinder the other party’s performance thereby excluding cases requiring a more active cooperation. Thus, the Working Group eventually agreed to rephrase the provision and introduced the criterion of reasonable expectations.¹⁶³⁵ It is argued that this criterion is objective, requiring an assessment of the question whether the “co-operation may be reasonably expected for the performance of the other party’s obligation”, and not whether the “other party may reasonably expect the cooperation.”¹⁶³⁶ However, there is no difference between those two questions, as the criterion cannot be entirely objective and the decision maker should also take into account the nature and purpose of the contract and the parties’ intentions in evaluating their specific allocations and reasonable expectations. Thus, the Official Comments to Article 5.1.3 provide a reference to the specific allocations in the context of the contract in determining the standard of reasonableness in a given case on the basis of whether the imposition of duty of cooperation would “upset the allocation of duties in the performance of the contract.”¹⁶³⁷

Article 1:202 of the PECL provides that “Each party owes to the other a duty to co-operate in order to give full effect to the contract.” This rule is included in the “Section 2: General Duties”, which consists of two provisions, the other one being the principle of good faith and fair dealing. The failure to cooperate when it is required under Article 1:202 constitutes a breach of the contract and consequently gives rise to all remedies the PECL provide for non-performance. Article 1:301 of the PECL, which defines “non-performance”, explicitly includes “failure to co-operate in order to give full effect to the contract” as an instance of non-performance.¹⁶³⁸ Therefore, the appropriate remedies are those that are set out in Chapter 9, which consists of performance, withholding performance, termination of the contract, price reduction and damages.¹⁶³⁹

In the Official Comments to the PECL, it is explained that the duty to cooperate requires one party to allow the other party to perform its obligations and thereby earn the fruits of performance stipulated in the contract.¹⁶⁴⁰ The illustrations of the comments provide specific instances that may arise from this general duty of cooperation. For instance, the duty to cooperate may impose an obligation to apply for a building license on an owner who has contracted to have office building erected, regardless of whether or not its contract with the contractor imposes on it an express obligation to apply for the license since, if the owner does not request it, the contractor cannot perform its obligation. The duty to cooperate may also concern a collateral duty if infringement of it prevents the other party’s performance, such as, a buyer’s undue failure to accept delivery of the seller’s goods is a breach of the duty to cooperate. The general duty to cooperate may give rise to the duties of information. In the official comments to Article 1:202, it is stated that a party has to inform the other party if the

¹⁶³⁵ UNIDROIT 1986 – P.C. – Misc. 8, Rome, February 1986 at 5-6

¹⁶³⁶ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 546

¹⁶³⁷ See also UNIDROIT 1987 – Study L – Doc. 39, Rome, April 1987, at 8

¹⁶³⁸ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 123

¹⁶³⁹ *Ibid.*, at 120

¹⁶⁴⁰ *Ibid.*, at 119

other party in performing the contract may not know that there is a risk of harm to persons or property.¹⁶⁴¹

As to the limits of duty to cooperate, the Official Comments to Article 1:202 of the PECL provides that the duty to cooperate is imposed only for the purpose of giving full effect to the contract. It is stated that a party does not infringe the duty to cooperate by failing to perform an act which it has not undertaken to perform and is of no interest to the other party. Moreover, the Official Comments further state that a party may refuse to cooperate, where its cooperation is dependent on an unfulfilled obligation by the other party in accordance with the right to withhold performance, under by Article 9:201(1), and in cases within Article 9:201(2) regarding anticipated non-performance by the other party.¹⁶⁴²

c. Contracting Practices

In international contracting practice, it is possible to find many instances of duty of cooperation in the contractual clauses. With regard to construction contracts, it is argued that the duty to cooperate is often implicit, yet seriously important and derived from the principle of good faith and fair dealing.¹⁶⁴³ The duty arises mainly as an obligation of each party to facilitate contract performance of the other party and to disclose relevant information. The FIDIC Conditions confirm the importance of cooperation between the parties. The FIDIC Conditions include a spirit of good faith in the contract, to the extent which was necessary to ensure that the progress of the construction works will not be adversely interfered with. There are specific clauses under the FIDIC Conditions, which ensure the cooperation between the Employer and the Contractor for the successful completion of the Works.

In a construction contract, the employer usually furnishes the work site, and it is in a better position to conduct subsurface investigations and to co-ordinate activities contractually with other contractors to promote co-operation between them and politically with government agencies to obtain permits.¹⁶⁴⁴ As the access to and possession of the site is essential for the completion of the works, the construction contracts commonly require the employer to give the contractor such possession, occupation or use as is necessary to enable it to perform the contract.¹⁶⁴⁵ Rules relating to “possession” or “use” or “access” or “occupation” are used in construction contracts to describe the contractor’s right to enter the site.¹⁶⁴⁶ According to Sub-Clause 2.1 of the FIDIC Conditions, the Employer shall give the Contractor right of access to, and possession of, all parts of the Site within the time stated in the contract or, if no such time is stated in the contract, within such times as may be required to enable the Contractor to proceed in accordance with the program submitted. If the Employer fails to comply with this form duty of cooperate, the Contractor is entitled to an extension of time, if completion is or

¹⁶⁴¹ Ibid., at 120

¹⁶⁴² Ibid., at 121

¹⁶⁴³ Molineaux, Charles, *Moving Toward a Lex Mercatoria - A Lex Constructionis*, *Journal of International Arbitration*, 14-1 (1997), at 64

¹⁶⁴⁴ Ibid.

¹⁶⁴⁵ In *The London Borough of Hounslow -v- Twickenham Garden Developments Ltd* (1970) 7 BLR 9, it was held that the contract necessarily requires the building owner to give the contractor such possession, occupation or use as is necessary to enable him to perform the contract.

¹⁶⁴⁶ Jaeger, Axel-Volkmar, & Götz-Sebastian Hök, *FIDIC - A Guide for Practitioners*, Springer-Verlag Berlin Heidelberg, 2009, at 181

will be delayed, and payment of any cost plus profit, which shall be included in the Contract Price. However, the Employer may withhold any such right or possession until the Performance Security has been received. This reflects the position of the Official Comments to Article 1:202 of the PECL, which refers to the right of the party undertaking the duty of cooperation to withhold performance due to non-performance by the other party of one or more obligations in accordance with Article 9:201 of the PECL.

The possession of site may not be exclusive to the contractor in some cases. According to Sub-Clause 4.6 of the FIDIC Conditions, the Contractor shall, as specified in the Contract or as instructed by the Engineer, allow appropriate opportunities for carrying out work to the Employer's Personnel, any other contractors employed by the Employer, and the personnel of any legally constituted public authorities, who may be employed in the execution on or near the Site of any work not included in the Contract. Additionally, services for these personnel and other contractors may include the use of Contractor's Equipment, Temporary Works or access arrangements which are the responsibility of the Contractor. On the other hand, Sub-Clause 2.3 requires that the Employer shall be responsible for ensuring that the Employer's Personnel and the Employer's other contractors on the Site cooperate with the Contractor's efforts under Sub-Clause 4.6, and take actions similar to those which the Contractor is required to take under Sub-Clause 4.8 (Safety Procedures) and Sub-Clause 4.18 (Protection of the Environment). The Contractor may rely on Sub-Clause 8.4 (Extension of Time for Completion) for any delay, impediment or prevention caused by or attributable to the Employer, the Employer's Personnel, or the Employer's other contractors on the Site.¹⁶⁴⁷

Pursuant to Sub-Clause 2.2, the Employer shall provide, at the request of the Contractor, such reasonable assistance as to allow the Contractor to obtain copies of the Laws of the Country relevant to the contract and with any applications for permits, licenses or approvals required by these Laws, which are not necessarily the same as stated as being the governing law of the Contract. Thus, Sub-Clause 2.2 explicitly require the parties, as reasonable merchants, to take into account and cooperate with each other to act in compliance with the mandatory rules of the national laws other than the one chosen by the parties as the governing law. According to the Sub-Clause 2.4, the Employer shall submit, before the Commencement Date and thereafter within 28 days after receiving any request from the Contractor, reasonable evidence that financial arrangements have been made and are being maintained which will enable the Employer to pay the Contract Price punctually in accordance with Clause 14 (Contract Price and Payment). Additionally, before the Employer makes any material change to his financial arrangements, the Employer shall give notice to the Contractor with detailed particulars.

There are many clauses under the FIDIC Conditions, which provide other duties to inform in order to foster cooperation between the parties for the successful progress of the Works. Pursuant to Sub-Clause 1.8, if a party becomes aware of an error or defect in a document which was prepared for use in executing the Works, that party shall promptly give notice to the other party of such error or defect. Sub-Clause 19.2 provides for duties to inform the other party in cases of force majeure. Sub-Clause 4.10 requires the Employer to make available to the Contractor all relevant data in the Employer's possession on sub-surface and hydrological conditions at the Site, including environmental aspects. In general, under various specific clauses, the Contractor, being in a better position to obtain the knowledge with regard to the works, is put under the obligation to supply information and notices required for the execution and completion of the Works and also for alerting the Employer, whenever an event occurs

¹⁶⁴⁷ Ibid., at 183

and is likely to increase the cost of the Work or the time for completion.¹⁶⁴⁸ The parties' failure to give such information, notices or alerts would be a breach of the terms of the contract, and may give rise to the Employer's claim for deduction in the Contract Price and Payment Certificates and/or extension of the Defects Notification Period under Sub-Clause 2.5, or to the Contractor's claim for additional payment and/or extension of the Time for Completion under Sub-Clause 20.1.

Other clauses that promote the cooperation between the parties can be found in the ICC Model Contracts on the turnkey supply of an industrial plant, mergers and acquisitions and commercial agency. All those ICC Model Contracts provide for a general clause on good faith and fair dealing. According to Article 2 of these model contracts, in carrying out their obligations under these agreements, the parties will act in accordance with the principles of good faith and fair dealing. It is further provided in Article 2 that the provisions of these agreements, as well as any statements made by the parties in connection with this agreement shall be interpreted in accordance with the principles of good faith and fair dealing.¹⁶⁴⁹ In the commentary to the ICC Model Commercial Agency Contract, it is explained that particular application of this principle will appear in the specific provisions of the model contract, but the concept of this principle is broader than any of the specific applications in the model contract, as the principle supplements those provisions. According to the commentary, Article 2 imposes upon each party a duty to observe reasonable standards of fair dealing and to show due regard for the interests of the other party and requires an interpretation in good faith which promotes the general principles on which the model contract is based.¹⁶⁵⁰

In the ICC Model Contract for the Turnkey Supply of an Industrial Plant, there are many contractual clauses which can be deemed as specific instances of duty of cooperation between the parties.¹⁶⁵¹ Particularly, Article 4.8, titled "Purchaser's duty to cooperate", provides, in general terms, that the Purchaser shall take all reasonable steps in order to assist the Supplier in performing obligations under this Contract. The second paragraph provides that the Purchaser shall obtain import permits and/or licenses required for any part of the Equipment in accordance with the applicable Incoterm and, to the extent applicable, building permits and operating permits, and he shall, at the Supplier's request, assist the Supplier in obtaining (temporary) import permits and/or licenses for Supplier's Erection Equipment, visa and/or

¹⁶⁴⁸ Bunni N.G., *The FIDIC Forms of Contract: the Fourth Edition of the Red Book, 1992, the 1996 Supplement, the 1999 Red Book, the 1999 Yellow Book, the 1999 Silver Book*, Blackwell Pub., 3rd ed., 2005, at 222

¹⁶⁴⁹ See Article 2 of ICC Model Mergers & Acquisitions Contract, International Chamber of Commerce, ICC publication, 656, Paris, 2004; Article 2 of ICC model contract for the turnkey supply of an industrial plant, ICC publication, 653, Paris, 2003; Article 2 of the ICC model commercial agency contract, 2nd ed., ICC publication, 644, Paris, 2002

¹⁶⁵⁰ Lando, Ole, *Commentary to Article 2*, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract*, A Commentary, ICC Publication No. 512, Paris, 1993, at 15-17

¹⁶⁵¹ See, for instance, Article 5.1 on Non-substantial alterations, in particular the Purchaser's duty not to unreasonably withhold its consent to the non-substantial alterations proposed by the Supplier; Article 6.2 on Sub-contractors and sub-suppliers, in particular the Purchaser's duty not to unreasonably withhold or delay its approval to the changes of sub-contractors or sub-suppliers proposed by the Supplier; Article 7.2 on the alterations to the time schedules, in particular the obligation of the parties to agree as soon as possible upon the corrections to be made to the Time Schedule in cases of delays in the performance of the contract except for force majeure situations; Article 31 on the defects in the plant after taking over, in particular, the Purchaser's duty to notify defects to the Supplier without undue delay, Supplier's duty to apply due and proper measures to make good the defect and the Purchaser's duty to apply all necessary measures to prevent or limit resultant damage.

work permits required in the country where the plant is to be installed for Supplier's personnel and any further authorizations, consents and/or approvals necessary for the performance of this Contract. Other instances of duty to cooperate can be found in Article 33 on Force Majeure which, in particular, provides the duty of the party invoking force majeure to notify the impediment, which causes the failure to perform, without undue delay and to take all reasonable means to limit the effect of the impediment or event invoked upon the performance of its contractual duties, and in Article 34.2 on the parties' duty to keep in strict confidence all confidential information obtained from each other in the course of performance of the contract and to use confidential information only to the extent necessary to fulfill its obligations under the contract and for the use of the plant.

The duty of cooperation can also be found in the ICC Model Mergers & Acquisitions Contract, Share Purchase Agreement. The complex nature of the cross-border share purchase agreements and the lengthy process leading up to their conclusion and performance require a certain degree of cooperation between the buyer and the seller. In most recent instances of merger and acquisitions, the cooperation between the parties starts, after the signing of a letter of intent, with a specific investigation, called "due diligence". Before acquiring shares in a company, the buyer or his agents investigate the legal, financial and operational situation of the target company.¹⁶⁵² Originally, "due diligence" was a qualification of the manner in which the buyer had to carry out these investigations, but, gradually, the practitioners have used this expression to define the investigation itself.¹⁶⁵³ In the course of this investigation, many documents may be reviewed by the audit team, usually in a data room, where all data useful for investigation are gathered for reasons of confidentiality. The seller is under the duty to disclose the documents relating to the business activities, corporate structure, assets and liabilities of the target company, and the buyer is under the duty to investigate them, and both of the parties are under the duty of confidentiality. The findings of the audit team as a result of their investigations affect the purchase price and they are recorded in the representation and warranties part of the final contract, and, sometimes in a disclosure letter annexed to the final contract, as a shield from attack as to the validity of purchase price based on mistake or misrepresentation.¹⁶⁵⁴ As the completeness of the information provided by the seller has great importance for structuring the transaction, a cooperative behavior between the parties is needed and often regulated explicitly in the contract. In the absence of explicit provisions, the duties of cooperation may be implied through the obligation of the buyer to conduct due diligence investigations carefully and respectfully with regard to the confidentiality of the information, and the obligation of the seller to disclose sensitive information or certain difficulties at that stage, without being expressly asked to do so by the buyer, in order to avoid the issues of mistake or misrepresentation.¹⁶⁵⁵

¹⁶⁵² For an example of a contractual clause setting out such an investigation see: "Article 4. Diligence of (Company X). As of the Effective Date, Purchaser or Purchaser's representatives, counselors and officers shall have right to inspect and examine the books and records pertaining thereto, and they shall have access to (Company X's) books and records, at all reasonable time during the Term, to the extent necessary for the proper performance of the due diligence and the application of the terms and conditions herein contained..." Cited by Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 201

¹⁶⁵³ *Ibid.*, at 201

¹⁶⁵⁴ *Ibid.*, at 146

¹⁶⁵⁵ Ehle, B. D., *Arbitration as a Disputes Resolution Mechanism in Mergers and Acquisitions*, *Comparative Law Yearbook of International Business*, (2005), at 292-293

The final contract, i.e. the share purchase agreement, also requires continuing cooperation between the buyer and seller in order to enable the closing, which means the completion of the sale and purchase of the shares of the target company by the parties' performance of their respective obligations, namely the shares or title documents are delivered against the payment. In this regard, Article 5 of the ICC Model Mergers & Acquisitions Contract requires that as from the date of execution of this agreement and until closing, the seller shall conduct the business of the company or cause the business of the company to be conducted in the ordinary course and notify the buyer of any material adverse change in the business operations, properties, prospects, assets or condition (financial or other) of the company, or any event, development or circumstances that may result in such a material adverse change. Moreover, share purchase agreements in some cases explicitly require the parties to cooperate with each other in satisfying conditions precedent to closing, particularly in obtaining notices, filings and consents required prior to the closing from any regulator in connection with the execution of the agreement and the performance of the obligations, including the notification of the agreement to the competition authorities, as well as in other closing actions.¹⁶⁵⁶

The ICC Model Mergers & Acquisitions Contract requires cooperation between the parties after the closing as well. According to Article 10 regarding claim procedure, whenever the buyer becomes aware that an event has occurred from which there may arise an obligation of the seller due to the breach of a warranty, the buyer shall, as soon as practicable, give claim notice to the seller. Then, in handling the event, the buyer shall keep the seller fully and promptly informed and consult in good faith with the seller before taking any material steps or decisions in order to allow the seller to make all recommendations and suggestions to the buyer in due time, and to this effect, the buyer shall give the seller reasonable access to relevant documentation and the seller shall provide full cooperation upon the buyer's reasonable request. Moreover, some other clauses reflect the negative aspect of cooperation after closing to avoid the unfair competition of the seller. Article 13.1 provides a non-competition clause, which prevents the seller from engaging in any activity and performing any services, which may be directly or indirectly in competition with the target company's business as per the closing date for a certain period of time which should be determined in accordance with the relevant mandatory rules of national laws. Similarly, Article 13.2 provides a non-solicitation clause, which prevents the seller from directly or indirectly soliciting, recruiting or discussing employment arrangements with any employee of the target company without prior consent of the buyer for a period of two years.

International commercial agency contracts also require a significant amount of cooperation between the parties, due to their long term nature and the closer confidence generated between the parties. The cooperative nature of these transactions was taken into account in the drafting of the ICC model commercial agency contract, which aims to provide a balanced agreement, respecting the legitimate interests of both parties, instead of giving a better protection to the principal or the agent.¹⁶⁵⁷ In the commentary, it is stated that both parties must act with diligence and good faith.¹⁶⁵⁸

¹⁶⁵⁶ Article 7.4 (Satisfaction of Conditions Precedent) and Article 8.4 (Closing Actions) Execution version of a Share Purchase Agreement dated 12 June 2006, on file with the author

¹⁶⁵⁷ Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract, A Commentary*, ICC Publication No. 512, Paris, 1993, at 4

¹⁶⁵⁸ Matray, Didier, *Commentary to Article 4*, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract, A Commentary*, ICC Publication No. 512, Paris, 1993, at 25 referring to Council Directive 86/653/EEC of 18

Under the ICC model commercial agency contract, the agent has duties of both active and passive cooperation. Article 9 of the ICC model commercial agency contract states the agent's obligation to keep the principal informed about his activities, market conditions and the state of competition within the territory and to answer any reasonable request for information made by the principal. The general purpose of this obligation is to enable the principal to evaluate the operations and to adapt his strategies to the particular conditions accordingly.¹⁶⁵⁹ According to the second paragraph of Article 9, the agent shall keep the principal informed about the laws and regulations of the territory relating to the products and his activity. Thus, Article 9 aims to protect the principal's interests in the territory through cooperation of the agent, who is in a better position to obtain information about the situation in the territory.¹⁶⁶⁰ Moreover, Article 10.1 provides that the agent shall not transmit orders from customers of which he knows or ought to know that they are in a critical financial position, without informing principal in advance and shall give reasonable assistance to the principal in recovering debts due. Article 11.4 requires the agent to notify the principal of any infringement of the principal's trademarks, trade names or symbols that comes to his notice. Article 12 requires the agent to immediately inform the principal of any observations or complaints received from customers relating to products and to cooperate with the principal in dealing with those complaints.

Article 5 of the ICC Model Commercial Agency Contract, titled "undertaking not to compete", imposes on the agent not to prejudice the principal's interests by the sale of competing products. Article 5 provides the agent's obligation not to represent, manufacture or distribute competing products during the term of the contract without the prior written authorization of the principal. It further provides that the agent should inform the principal in advance of his activities of representing, distributing or manufacturing other products which are not competing with the principal's product unless it is unreasonable to expect that the principal's interests may be affected.

The principal has also duties of both active and passive cooperation under the ICC Model Contract on Commercial Agency. Article 4 provides that the principal must inform the agent without undue delay of his acceptance or rejection of the agent's orders and principal may not unreasonably or contrary to good faith reject the agent's orders.¹⁶⁶¹ Article 14 declares the principal's duty to provide the agent with all necessary information relating to the products as well as with the information needed by the agent for carrying out his obligations under the contract. The principal is also required to inform the agent if he expects that his capacity of supply will be significantly lower than that which the agent could normally expect. Finally, according to Article 16, the agent is entitled to all the information, particularly extracts from the principal's books, in order to check the amount of commission due to him.¹⁶⁶²

December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents Article 4.1: "In his relations with his commercial agent a principal must act dutifully and in good faith."

¹⁶⁵⁹ Bortolotti, Fabio, Commentary to Article 9, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract*, A Commentary, ICC Publication No. 512, Paris, 1993, at 42

¹⁶⁶⁰ Bortolotti, Fabio, Commentary to Article 10, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract*, A Commentary, ICC Publication No. 512, Paris, 1993, at 45

¹⁶⁶¹ Repeated rejection of orders done contrary to good faith may enable the agent to claim substantial breach of contract under Article 20.3.

¹⁶⁶² The commentary refers to Article 12.2 of Council Directive 86/653/EEC of 18 December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents, which provides that

On the other hand, Article 13 provides that the principal shall not, during the life of the contract, grant any other person or undertaking within the agreed territory the right to represent or sell the contractual products. In the commentary, it is explained that in principle it is agent's interests to obtain full exclusivity in order to benefit from all the fruits of the operations in his territory, and contracts providing that the agent has no exclusive rights at all are very rare. The latter situation may be justified in cases, such as when the agent refuses to accept a non-competition obligation.¹⁶⁶³ According to the second paragraph of Article 13, the principal is entitled to deal directly with any customers in the territory provided that he informs the agent, who will be entitled to commission.

2. Arbitral Decision Making

While the civil law systems seems more permissive to the implication of a duty to cooperate in the contract under the overarching principle of good faith and fair dealing, which is generally followed by the international restatements of contract principles, the common law systems traditionally limit the extent of the duty to cooperate to the terms implied in fact in order not to disturb the contractual equilibrium. On the other hand, despite the influence of the common law systems, the contracting practices relating to the transactions governed through legal uncertainty demonstrate the importance of cooperation and the variety of clauses that impose duties of cooperation on both parties. Such practices can be construed as reflecting the change from the classical paradigm of self-interested dealing to a model of cooperative dealing. In civil law systems, due to the variety of situations, in which the contractual cooperation may be imposed on the parties through the principle of good faith on the basis of cooperative dealing, the legal sources of duties of cooperation are generally derived from the legal doctrine and case law, while the legislative acts being limited to providing general principles and placed in secondary position. However, even in the national legal systems admitting the principle of good faith and the international restatements, the decision maker is generally required to give effect to the risk allocation agreed by the parties in the contract and to evaluate the impact of implication of the various duties of cooperation into the contract, given the serious consequences of such implication, on the basis of the discretionary power of the decision maker, in terms of contractual liability and availability of remedies to the parties.

a. Basis of Cooperation

The basic principle of good faith and fair dealing has generally been considered as the basis of various duties of cooperation between the parties at the stage of negotiations as well as throughout the life of the contract. These duties are based on similar premises and are defined by the same considerations.¹⁶⁶⁴ In particular, they are based on loyalty, and considered as allowing the solution of any difficulties connected with the fulfillment of the contract and in carrying out its purpose.¹⁶⁶⁵ It is argued that the principle that each party to a contract owes a

“ A commercial agent shall be entitled to demand that he be provided with all the information, and in particular an extract from the books, which is available to his principal and which he needs in order to check the amount of the commission due to him.” Matray, Didier, Commentary to Article 16, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract, A Commentary*, ICC Publication No. 512, Paris, 1993, at 68

¹⁶⁶³ Ferrier, Didier, Commentary to Article 13, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract, A Commentary*, ICC Publication No. 512, Paris, 1993, at 53-54

¹⁶⁶⁴ Nassar, Nagla, *Sanctity of Contracts Revisited : a Study in the Theory and Practice of Long-Term International Commercial Transactions*, M. Nijhoff, 1995, at 156

¹⁶⁶⁵ Robin, Guy, *The Principle of Good Faith in International Contracts*, *International Business Law Journal*, (2005), at 717

duty not to cause prejudice but rather to cooperate with its partner in order to solve the complex problems which arise in long-term contractual relationships has been repeatedly affirmed by international arbitral tribunals.¹⁶⁶⁶ In ICC Case No 2443, the arbitral tribunal stated that the parties must be aware that only a loyal, complete and continuing cooperation between them may assist in resolving, beyond the difficulties inherent to the performance of each contract, the many problems arising from the extreme complexity and entanglement of the litigious obligations, and this obligation to cooperate, which the modern doctrine rightly found on the good faith that has to govern the performance of any obligation, must be complied with.¹⁶⁶⁷

In ICC Case No 9797, the sole arbitrator held that one of two business units consisting of member firms of a global consulting firm that were linked to each other through a number of Member Firm Interfirm Agreements had acted contrary to the member firms' implicit obligation to cooperate and to pursue their professional practice in accordance with the principle of good faith and fair dealing. The arbitrator found the member firms of one of the business units were responsible for breaches of such obligations as hiring away the personnel of the member firms of other business unit, and misleading their clients in order to sell their own services and trading on their credentials and expertise. Although the agreements did not contain any express provisions prohibiting such conducts, the arbitrator held that the contractual agreements among the parties forbid the member firms to engage in uncooperative acts to benefit themselves at the expense of other member firms and such acts were "contrary to the member firms' implicit obligation ... to pursue their professional practice in accordance with the principle of good faith and fair dealing inherent to international contracts" and referred to Article 1.7 of the UNIDROIT Principles.¹⁶⁶⁸

It is argued in the doctrine that "The needs of international trade give rise . . . to the creation of a-national rules which, taking account of the hazards and costs of international commercial operations, impose co-operation in good faith upon the parties whose scope exceeds that normally required by national law in internal operations"¹⁶⁶⁹ In ICC Case No 5030, the arbitral tribunal underlined a general obligation to behave with loyalty in the contractual relationship, which, in its view, constitutes naturally an essential principle in international economic relations.¹⁶⁷⁰ However, the implication of a duty to cooperate may have serious consequences, such as obstructing the exercise of the contractual rights as agreed by the parties or leading to significant changes in the available remedies. In ICC Case No 10346, the arbitral tribunal, referring to Article 1175 of the Italian Civil Code, the legislation which the applicable Colombian law took as its model for the subject of obligations and contracts, and

¹⁶⁶⁶ Bernardini, Piero. Is the Duty to Cooperate in Long-Term Contracts a Substantive Transnational Rule in International Commercial Arbitration?, in Emmanuel Gaillard (ed.), *Transnational Rules in International Commercial Arbitration*, ICC Publication No. 480/4, Paris 1993, at 139

¹⁶⁶⁷ ICC Award in Case No. 2443, 1975, cited in the French original in the commentary to ICC Award No. 2291, *Collection of ICC Arbitral Awards*, Vol. I (1974-1985), at 276

¹⁶⁶⁸ ICC Award in Case No. 9797, July 28, 2000, *Andersen Consulting Business Unit Member Firms vs. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative*, *World Trade and Arbitration Materials*, 12-5 (2000), at 162

¹⁶⁶⁹ Loquin, E., *L'application de regles nationales dans l'arbitrage commercial international*, in *L'apport de Law Jurisprudence Arbitrale, Les Dossiers de L'Institut du Droit et des Pratiques des Affaires Internationales*, (1986), at 98-99, cited in *Observations on ICC Award in Case No. 5832*, *Collection of ICC Arbitral Awards*, Vol. II (1986-1990), at 536

¹⁶⁷⁰ ICC Award in Case No. 5030, *Journal du Droit International* (1993), at 1011

Article 1.7 of the UNIDROIT Principles, stated that “the party, specifically the creditor, who has not acted with the diligence, measures and foresight which are required of him, as the case may be, is not only disqualified from alleging a breach of contract and seeking compensation for damages which, in the event that they have been suffered, would be due to his own fault, but, on a preventative and more direct basis, assumes the consequences of his dishonesty or turpitude and the attendant liability towards the other party...”¹⁶⁷¹ Thus, in supplementing the contract with the duties of cooperation, the decision maker applying *lex mercatoria* should refrain from relying entirely on the concept of good faith and fair dealing without further justification and provide sufficient insight into the abstract reasoning that forms the basis of his specialized consolidations.

The ICSID case, between *Klöckner v. Cameroon*, where the obligation to keep other party fully informed, as expressed in the award as “the duty of full disclosure”, was applied in the context of a long-term contract, demonstrates the problems arising from such a wide consideration of the duty of cooperation in an arbitral award. The dispute arose out of a number of agreements, under which Klöckner undertook to supply and erect a fertilizer factory in Cameroon, supported by feasibility and profitability studies prepared by Klöckner. Klöckner would be responsible for technical and commercial management of the factory for at least five years, and become a 51% shareholder in the joint venture operating company (“SOCAME”). The Cameroonian Government undertook to furnish a developed site for the factory as well as to guarantee payment of a loan, arranged by Klöckner, covering the price of the factory. After 18 months of unprofitable and sub-capacity operation, the factory was shut down in 1978. After a failure to attempt by Cameroon to start up the factory in 1980, the Government ultimately decided to close the factory in 1981. Klöckner filed a request for ICSID arbitration claiming the balance of the price for supplying the factory, namely 80 per cent of the price.¹⁶⁷² The award declared the debt of the Cameroonian Republic cancelled by reason of Klöckner's failure to perform its contractual obligations.

Klöckner and Cameroon had not agreed on the applicable law in the agreements, but it was not contested by the parties during the proceedings that the applicable law should “naturally” be “the civil and commercial law applicable in Cameroon”. However, the sources of this law could not be determined without difficulty because the United Republic of Cameroon had a dual judicial heritage from both France and the United Kingdom during the colonial era. Since the SOCAME factory project and finalization of relevant agreements took place in the eastern part of the country, the tribunal held that only that part of Cameroonian law that was based on French law should be applied in the dispute. On the basis of this law, the tribunal defined a “duty of full disclosure to a partner” without referring to any precise legal texts.¹⁶⁷³

The tribunal considered that, “[d]uring the critical period before and during the construction of the factory, Klöckner failed to meet its obligation to deal frankly with its Cameroonian partner.”¹⁶⁷⁴ The tribunal stated: “This was a joint venture between Klöckner, a multinational European Corporation, and a developing country. The plant to be built was an example of

¹⁶⁷¹ ICC Award in Case No. 10346, December 2000, ICC International Court of Arbitration Bulletin, 12-2 (2001), at 112

¹⁶⁷² Paulsson, Jan, *The ICSID Klöckner v. Cameroon Award: The Duties of Partners in North-South Economic Development Agreements*, *Journal of International Arbitration*, (1984), at 145-146

¹⁶⁷³ *Ibid.*, at 157

¹⁶⁷⁴ *Ibid.*, at 154

imported modern technology and engineering. Cameroon had no experience in manufacturing fertilizer products. The factory was to be acquired with the Government's guarantee of payment; its output being of major importance for the country's agriculture, and agriculture being in turn the very foundation of Cameroon's economic ambitions. Cameroon counted on Klöckner to supply all that was necessary to ensure the success of the project... Klöckner claimed to be capable of supplying all the knowhow, all the material, and all the management skills necessary to ensure the project's success, the Government's only role being to supply a site and to guarantee payment of the contract price. In this operation, the Government trusted Klöckner. Klöckner ... promised its partner, if not an unconditional guarantee of the factory's profitability at all times, at least very pronounced frankness and loyalty. Klöckner had a particularly strong obligation to keep Cameroon informed of any facts that might have a crucial influence upon the Government's decision to assume, and to continue assuming, the very onerous financial engagements upon which Klöckner now seeks to rely. Klöckner failed to live up to these obligations. We do not hold that this failure was due to a fraudulent intent. But we conclude that Klöckner demonstrated less than a full measure of frankness, of candor, vis-à-vis its partner, and that what it did not disclose to its partner may have been decisive in the Government's decision whether or not to pursue the project. We thus hold that Klöckner did not respect its duty of confidence and loyalty vis-à-vis its partner in this joint venture.”¹⁶⁷⁵

According to the tribunal, Klöckner failed to make adequate efforts to deal frankly with its partner, because it could have said that the conditions of financing had become tougher, and prices had changed since the initial agreement. The tribunal considered that “It is impossible to determine whether the Government would have decided to halt the project if Klöckner had revealed clearly and fully to the Government that the economic hypotheses of 1971 [at the signing of the basic agreement], with respect to the relative prices of raw materials and finished products as well as to the definitive price of the factory, were no longer valid.”¹⁶⁷⁶ However, the tribunal was sure that if Klöckner had taken back its initial representations concerning the profitability of the factory to take account of the new realities of the international fertilizer market, Cameroon could have reconsidered and avoided the costly and unwise investment.¹⁶⁷⁷

The tribunal stated that “We take for granted that the principle according to which a person who engages in close contractual relations, based on confidence, must deal with its partner in a frank, loyal and candid manner is a basic principle of French civil law, as is indeed the case under the other national codes which we know of. This is the criterion that applies to relations between partners in simple forms of association anywhere. The rule is particularly appropriate in more complex international ventures, such as the present one. We have not established that there is a law applicable to such contracts. We do not intend to apply new or exceptional legal principles to turn-key operations only because they concern projects affecting the economic and social development of a given country. But we are convinced that it is particularly important that universal requirements of frankness and loyalty in dealings between partners be applied in cases such as this one, where a multinational company seeks and freely undertakes the obligation to supply an overall package of feasibility, analysis, design, management, bidding, construction and marketing for an industrial plant, and obtains in return the agreement of the Government to pay for the factory, whether or not it is profitable. In the

¹⁶⁷⁵ Ibid., at 154-155

¹⁶⁷⁶ Ibid., at 155

¹⁶⁷⁷ Ibid., at 157

present case, as we have suggested, we do not feel that Klöckner has dealt frankly with Cameroon. At critical stages of the project, Klöckner hid from its partner information of vital importance. On several occasions it failed to disclose facts which, if they had been known to the Government, could have caused it to put an end to the venture and to cancel the contract before the expenditure of the funds whose payment Klockner now seeks to obtain by means of an award. When a partner in a financially complex international venture learns of certain facts which could influence the attitudes and the actions of the other partner with respect to the project; when the first partner fails to disclose this information to the other; and the second thereupon continues with the project and incurs additional costs, the first partner has not acted frankly and loyally vis-à-vis his partner, and he cannot rightly present a claim to funds whose expenditure would perhaps never have been necessary if he had been frank and candid in his dealings. In a very significant sense, the fault is his. The fact that the funds were spent becomes his responsibility and not that of his partner. In this respect, we decide that Klöckner violated its fundamental contractual obligations and may not insist upon payment of the entire price of the Turnkey Contract.”¹⁶⁷⁸

The tribunal found that the government was well founded in retaining payments under the *exceptio non adimpleti contractus* by reaching “the conclusion that Klockner violated its duty of full disclosure,” and therefore “it is not entitled to the contract price, that it is entitled to payment for the value of what it delivered and which Klockner used, and that Cameroon has already paid enough. . . .”¹⁶⁷⁹ In the application of the *exceptio non adimpleti contractus*, the tribunal first analyzed and discussed French case law and commentary, while also noting “in view of the parties' divergence as to applicable law... that English law and international law reach similar conclusions”.¹⁶⁸⁰ The tribunal held that “In the present case, taking into account, on the one hand, the significant payments effected by Defendant, and, on the other hand, the significance of Claimant's failures to live up to contractual undertakings, it is appropriate to conclude that the amount paid corresponds equitably to the value of Klöckner's defective performance... and we have thus concluded that Klöckner is entitled to what it has already received, but to nothing more.”¹⁶⁸¹ The tribunal also denied Cameroon's counter-claim for damages for reparation of all losses attributable to its participation in the project, *lucrum cessans*, and non-financial damages. The tribunal stated that “There is no justification for charging Claimant with the losses incurred by the Government in a joint venture where the two parties participated, or should have participated, with open eyes and full understanding of their actions. One could hardly accept that a State, having access to many sources of technical assistance, could be entitled to compensation for the fact that it was misled by a private company proposing a particular contract... Klöckner's responsibility for the defects in the supply of the factory and in its technical and commercial management have been sufficiently sanctioned by the rejection of its claim under the unpaid promissory notes. For the same reasons, there is no ground in this case to allocate *lucrum cessans* or compensation for any non-financial damages.”¹⁶⁸²

¹⁶⁷⁸ Ibid., at 157-158

¹⁶⁷⁹ The decision of the Ad hoc Committee, dated May 3, 1985, ICSID Review--Foreign Investment Law Journal, (1986), at 111

¹⁶⁸⁰ Paulsson, Jan, The ICSID Klöckner v. Cameroon Award: The Duties of Partners in North-South Economic Development Agreements, Journal of International Arbitration, (1984), at 159

¹⁶⁸¹ Ibid., at 166

¹⁶⁸² Ibid., at 168

D. Schmidt, who was appointed by Klöckner as a member of the tribunal, criticized the award in his dissenting opinion.¹⁶⁸³ With regard to the “duty of full disclosure to a partner”, the dissenting arbitrator noted that “it is not reasonable to claim that the Government of Cameroon was not aware of “the relative prices of raw materials and finished products”, when in fact that Government was in total control of the fertilizer market through its power to deliver import licences for fertilizers, through its calls for international tenders, through its control of the whole fertilizer distribution network in Cameroon, and through the fixing by administrative order of the sale price for fertilizers in Cameroon. One may well wonder what conceivable information Klöckner could have revealed to the Government of Cameroon which that Government did not know already, with regard to fertilizer prices”.¹⁶⁸⁴ According to the dissenting arbitrator, the award also suffered from an obvious self-contradiction in its reasons since, on the one hand, the award confirmed the full awareness on the part of the Government of Cameroon and its access to many sources of technical assistance in rejecting the Government’s counter-claim, which was precisely based on the alleged non-disclosure of Klöckner and, on the other hand, the alleged non-disclosure was instrumental in the rejection of the main claim of Klöckner.¹⁶⁸⁵

Klöckner applied for the annulment of the award under Article 52 of the ICSID Convention, alleging, among others, that the tribunal had manifestly exceeded its powers due to a violation of Article 42(1) of the Convention. Klöckner maintained that the tribunal had to render its award by applying Cameroonian law based on French law, since this, as the tribunal itself held, was the law applicable to the present dispute, but the tribunal “ignored this principle and went beyond its powers.”¹⁶⁸⁶ The ad hoc Committee noted that, in imposing “the duty of full disclosure to a partner”, “the Tribunal does not claim to ascertain the existence (of a rule or a principle) but asserts or postulates the existence of such a “principle” which (after having postulated its existence) the Tribunal assumes or takes for granted that it “is a basic principle of French civil law”.”¹⁶⁸⁷ The Committee emphasized the contrast between the section on the “duty of full disclosure”, which contained no reference whatsoever to legislative texts, to judgments, or to scholarly opinions, and the section on the *exceptio non adimpleti contractus*, which contained a great number of references to scholarly opinion as well as, directly or indirectly, to case law. The Committee stated that although the principle of good faith is “at the basis” of French civil law, as of other legal systems, this elementary proposition does not by itself answer questions, such as whether the “duty of full disclosure” exists in Cameroonian

¹⁶⁸³ Niggemann, Friedrich, *The ICSID Klöckner v. Cameroon Award: The Dissenting Opinion*, *Journal of International Arbitration*, (1984), at 331

¹⁶⁸⁴ *Ibid*, at 334

¹⁶⁸⁵ *Ibid*, at 334-335; Klöckner raised this issue in the annulment proceedings and complained that the award contained a contradiction of reasons, which it held to be equivalent to a failure to state reasons. According to Klöckner, “in order to dismiss Klöckner’s claim, the Tribunal holds that it “could have deceived” the Cameroonian Government, while in dismissing the Cameroonian Government’s claim, it emphasizes that the latter could not have been deceived.” The Committee explained that the true reason for the tribunal’s award on the first point was not that there was or could have been deception, but that there was omission or dissimulation on the part of the Claimant, and whether Cameroon was deceived or not would not change the award’s refusal of the counter-claim, since Cameroon was presumed to have acted with either full understanding or with open eyes, and even if it had been actually “misled,” the Government would have a “concurrent responsibility” which excludes the counter-claim. Thus, the Committee held that, in reality, the two reasons were not contradictory, despite certain ambiguities in language, and rejected the complaint. The decision of the ad hoc Committee, dated May 3, 1985, *ICSID Review--Foreign Investment Law Journal*, (1986), at 127

¹⁶⁸⁶ *Ibid*, at 109

¹⁶⁸⁷ *Ibid*, at 111

or Franco-Cameroonian law, and how is it implemented and within what limits.¹⁶⁸⁸ According to the Committee, “in the absence of any information, evidence or citation in the award, it would seem difficult to accept, and impossible to presume, that there is a general duty, under French civil law, or for that matter other systems of civil law, for a contracting party to make a “full disclosure” to its partner.” The Committee stated that “the Award’s reasoning and the legal grounds on this topic (to the extent that they are not in any case mistaken because of the inadequate description of the duty of “full disclosure”) seem very much like a simple reference to equity, to “universal” principles of justice and loyalty, such as amiable compositeurs might invoke.” Considering that the duty of full disclosure was apparently the main ground of the decision, the Committee found it impossible to explain how the award can base such a duty on a simple postulate or a presumption that there is a “basic principle,” without any argumentation whatsoever, and without touching on rules defining how this “principle” is to be applied, i.e., the respective rights and duties of the debtor and the creditor, the duty of disclosure, of frankness and loyalty, in general and in this particular case, as well as the legal effects of a breach of this duty. The Committee concluded that “in its reasoning, limited to postulating and not demonstrating the existence of a principle or exploring the rules by which it can only take concrete form, the Tribunal has not applied “the law of the Contracting State.””¹⁶⁸⁹ The Committee held that, however justified its award may be, the tribunal “manifestly exceeded its powers” within the meaning of Article 52(1)(b) of the ICSID Convention as the tribunal acted outside the framework of Article 42(1) by applying concepts or principles it probably considered equitable.¹⁶⁹⁰

It is argued with regard to Klöckner award that although French law provides in certain situations, such as those concerning consumer contracts, “that the party in dominant position has an obligation to give certain information to the other contracting party. . . it would be wrong to assume that in regard to contracts which are conducted at arm’s length, there would be a general duty of “full disclosure” such as the one advocated by the majority of the tribunal going beyond the elementary requirements of good faith”¹⁶⁹¹. Essentially, in the reasoning of the tribunal in Klöckner case, the existence of a North-South relationship between a company from an industrialized country and a developing state was apparently sufficient to trigger the wider application of the principle of good faith, leading to the imposition of a duty of “full disclosure” on the former. However, such reasoning seems excessive for its inference by which a developing state is likened to a layman, while the company from an industrialized country to a technician. The context of the contract may contradict such presumptuous inferences as to the professional competences of the parties, as underlined by D. Schmidt in his dissenting opinion, and as can be observed from the ambiguous opinion of the majority of

¹⁶⁸⁸ Ibid, at 113

¹⁶⁸⁹ Ibid., at 114

¹⁶⁹⁰ Ibid., at 115; Klöckner also complained that the tribunal failed to state why it thought the exception *non adimpleti contractus* under French law could be applied as it was in the Award. The Committee considered that while the award contained some reasoning on the conditions for applying the exception based on non-performance, the award did not state the legal grounds nor did it state the rules of civil law, reinforced by references to scholarly opinion and case law comparable to those which the award cited on the general principle, which could justify its conclusions as to the effects of the exception based on non-performance. According to the Committee, everything occurred as if the tribunal had considered the *exceptio non dimpleti contractus* as a ground for extinguishing obligations under French law but, on the basis of the award’s own citations, this conclusion did not necessarily follow, but in any case it should have been expressly justified. Thus, the Committee held that the complaint that there was a failure to state reasons was not only admissible but well founded. Ibid., at 141-142

¹⁶⁹¹ Delaume, Georges, *The Proper Law of State Contracts and the Lex Mercatoria: a Reappraisal*, ICSID Review—Foreign Investment Law Journal, 3 (1984), at 96-97

the tribunal as to the abilities of the Government to obtain the relevant information. Although, the contracts which require long-term cooperation between the parties can give rise to specific instances of duties of cooperation, the question of whether the parties' obligations should be assessed differently in economic development contracts is too controversial to generate general principles of law.¹⁶⁹²

It is true that the transactions governed through legal uncertainty, which are characterized by their long duration, complexity or innovative features, create between the parties such close links that imply that there is a duty upon them to cooperate towards a common aim so as to permit to each party to attain its own objectives. The parties acknowledge the importance of their cooperation in achieving the objectives set out by their transactions by specifying the instances of required cooperation in the contractual clauses to the extent they are willing to incur transaction costs, thereby regulating the consequences of duty to cooperate. Thus, it is observed, in international contracting practice, that there are many specific instances of duty of cooperation in the clauses of transactions governed through legal uncertainty. However, in supplementing the contract with duties of cooperation or interpreting the scope of such duties as articulated in the contract in order to ascertain the meaning and content of the contract, the decision maker applying *lex mercatoria* should take into account not only the basic principle of good faith and fair dealing, but also those of freedom of contract and sanctity of contract.

The decision maker applying *lex mercatoria* should not reduce the constituent elements of the duty of cooperation solely to the nature and purpose of the contract in question and the status of the parties as loyal partners. These elements may indicate the conditions and degree of the parties' reasonable expectation of cooperation throughout the life of the contract to achieve its purpose, but the context of the contract and other objective considerations, such as the relevant trade usages and contracting practices, are also important factors in the *ex post* supplementation of an incomplete contract with the duties of cooperation. The decision maker should also refer to the articulated rules, which may include the rules of a national law chosen by the parties, or the rules of a national law, which is found to be applicable by the decision maker and which can be relevant to the identification of the established rules and the reasonable expectations of the parties in the particular case. As the *ad hoc* Committee in Klöckner case pointed out, "Of course, one can only applaud the Award's emphasis on the importance of loyalty in dealings, especially in international contracts of the sort which gave rise to the present arbitration, but such approbation cannot exempt the Committee from ascertaining whether the conditions of Article 42 of the Washington Convention have been met."¹⁶⁹³

On the other hand, in the ICSID case between MINE v. Guinea, the tribunal relied on the principle of good faith under French law, rather than the applicable Guinean law, in imposing a duty of cooperation in the form of a passive behavior, which precluded Guinea from secretly negotiating and entering into contracts with third parties, the effect of which would frustrate the purpose of its agreement with MINE, yet such application was not regarded by the *ad hoc* Committee as a violation of Article 42 of the ICSID Convention. The dispute concerned the "Convention" for ocean transportation of bauxite and the establishment, for thirty years, of a mixed-economy company, called SOTRAMAR, in which MINE and Guinea were

¹⁶⁹² Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 828

¹⁶⁹³ The decision of the *ad hoc* Committee, dated May 3, 1985, ICSID Review--Foreign Investment Law Journal, (1986), at 113

shareholders. The purpose of SOTRAMAR was to combine MINE's international shipping expertise with Guinea's freight rights, which it obtained under Article 9 of the agreement between Guinea and Harvey Aluminum Company, giving Guinea the right to transport up to 50% of the exported tonnage, provided Guinea could do so at freight rates not in excess of market rates.¹⁶⁹⁴ SOTRAMAR would carry out the transportation of 50 % of the Guinean bauxite that had been sold to several western companies (the "Bauxite Receivers"). SOTRAMAR encountered serious difficulties in obtaining contracts of affreightment with the Bauxite Receivers. The parties established the SOTRAMAR Shipping Committee to negotiate with the Bauxite Receivers, which resulted in the acceptance by the latter of freight rates which, according to MINE, would be profitable to SOTRAMAR. However, according to MINE, SOTRAMAR had not received authority from Guinea to conclude contracts of affreightment and the purpose of SOTRAMAR was frustrated. Later, MINE became aware that Guinea was negotiating about the Article 9 freight rights with a third party, AFROBULK.

MINE initiated arbitration proceedings, arguing that Guinea breached the Convention when it secretly negotiated and subsequently contracted with AFROBULK. Guinea contended that it lost all confidence in MINE's professional ability, arguing that it was MINE which had breached the Convention by failing to conclude contracts of affreightment and that Guinea's arrangement with AFROBULK was a legitimate measure in mitigation of damages.¹⁶⁹⁵ The tribunal rejected Guinea's defense, and found that that MINE did not breach the Convention in failing to conclude contracts of affreightment. The tribunal noted that Guinea did not try to renegotiate the agreement, or to substitute another company for MINE in SOTRAMAR. The tribunal considered that, before concluding an agreement with AFROBULK, Guinea never suggested to MINE either that SOTRAMAR should negotiate with third party carriers to exercise the Article 9 freight rights, or that the sort of arrangement, which was ultimately concluded with AFROBULK, was one that SOTRAMAR ought to consider on a short term basis. According to the tribunal, there was little doubt that MINE could easily have negotiated such an arrangement on behalf of SOTRAMAR if Guinea had expressed the desire. Although Guinea described the AFROBULK arrangement as a temporary measure designed to permit SOTRAMAR to become a functioning and operational organization, the tribunal found that Guinea's entering the AFROBULK agreement was contrary to the spirit and express provisions of the Convention, because SOTRAMAR was the only organization represented to the Bauxite Receivers as authorized user of the Article 9 freight rights.¹⁶⁹⁶ The tribunal held that "Guinea's conduct in secretly negotiating the AFROBULK arrangement, and in denying its existence to MINE thereafter, exhibits bad faith on its part, violating the principle of good faith set forth in [Article 1134 of] the French Civil Code".¹⁶⁹⁷ The tribunal concluded that "Guinea prevented SOTRAMAR from performing under the Convention, and thereby breached the Convention when Guinea entered the AFROBULK agreement".¹⁶⁹⁸

¹⁶⁹⁴ Ad Hoc Committee, *Maritime International Nominees Establishment v. Republic of Guinea*, Decision partially annulling the award, December 22, 1989, *ICSID Review—Foreign Investment Law Journal*, 5 (1990), at 106

¹⁶⁹⁵ *Ibid.*, at 110

¹⁶⁹⁶ *ICSID Award January 6, 1988, Maritime International Nominees Establishment (MINE) v. The republic of Guinea*, *Yearbook Commercial Arbitration*, 14 (1989), at 87

¹⁶⁹⁷ *Ibid.*, at 87-88

¹⁶⁹⁸ *Ibid.*, at 88

Guinea requested the annulment of the award pursuant to Article 52 of the ICSID Convention. Guinea argued, among others, that the tribunal has manifestly exceeded its powers by violating its obligation to decide the dispute “in accordance with such rules of law as may be agreed by the parties”, and that the tribunal “failed to apply any law whatsoever, much less correct law” as to the liability, although the Convention provided that Guinean law was the applicable law.¹⁶⁹⁹ Guinea stated that “Most notable is the almost total lack of citation to legal authorities. The single legal reference is contained in one footnote, citing an article of the French Civil Code as it appears in Louisiana law.”¹⁷⁰⁰ The ad hoc Committee first stated that “the parties' agreement on applicable law forms part of their arbitration agreement. Thus, a tribunal's disregard of the agreed rules of law would constitute a derogation from the terms of reference within which the tribunal has been authorized to function. Examples of such a derogation include the application of rules of law other than the ones agreed by the parties, or a decision not based on any law unless the parties had agreed on a decision *ex aequo et bono*. If the derogation is manifest, it entails a manifest excess of power.” However, the tribunal also noted that “disregard of the applicable rules of law must be distinguished from erroneous application of those rules which, even if manifestly unwarranted, furnishes no ground for annulment”.¹⁷⁰¹ The Committee stated that it is aware of the fact that Guinean law is independent of French law, although derived from it. According to the Committee, although certain discrepancies may be found between French law as applied in France, and local Guinean law, this was not the case as far as Article 1134 of the “Code Civil” is concerned.¹⁷⁰² The Committee stated that “There is thus no basis for saying that the Tribunal failed to apply any law. Admittedly, the Tribunal erred in citing Article 1134 of the French Civil Code. The Committee notes, however, that the relevant provision of the applicable Guinean law is contained in the “Code Civil de l'Union Française” with the same number and the same contents as Article 1134 of the French Civil Code. For this reason, the Committee does not consider that this error warrants annulment.”¹⁷⁰³ Thus, the Committee concluded that the tribunal did not fail to apply the “correct” law and did not manifestly exceed its power. Guinea also complained that the tribunal failed to deal with its arguments on the limits of good faith and on its right to conclude the agreement with AFROBULK in response to MINE's prior refusal to go forward without Guinea's relinquishing its contractual rights. However, the Committee noted that this complaint was based on the assumption, contrary to the tribunal's finding, that MINE was in breach of the Convention and it was in effect an appeal against the tribunal's decision on breach of contract, but appeal is excluded by the ICSID Convention.¹⁷⁰⁴

In practice, the arbitrators often apply the principle found in the applicable national law, such as Article 1134 (3) of the French Civil Code, as well as those of many codifications in civil law systems, according to which “contracts must be performed in good faith” in

¹⁶⁹⁹ Ad Hoc Committee, *Maritime International Nominees Establishment v. Republic of Guinea*, Decision partially annulling the award, December 22, 1989, *ICSID Review—Foreign Investment Law Journal*, 5 (1990), at 104

¹⁷⁰⁰ *Ibid.*, at 112

¹⁷⁰¹ *Ibid.*, at 104

¹⁷⁰² *Ibid.*, at 112

¹⁷⁰³ *Ibid.*, at 113

¹⁷⁰⁴ *Ibid.*, at 115

supplementing the contracts with various duties of cooperation.¹⁷⁰⁵ However, such activities of supplementation should not lead to a wider consideration of good faith obligations in contravention to the nature of the contracts and the parties in the order of international commerce, such as those that can be relevant in the context of contracts between parties of unequal bargaining power or professional competence. It is observed that there is a tendency among arbitrators in international commerce to consider that the law should only protect parties to the extent that they are not under a duty to protect themselves.¹⁷⁰⁶ As long as the facts of the case are carefully examined and accounted for in the application of the principle of good faith, as in the ICSID case between *MINE v. Guinea*, the decision maker applying *lex mercatoria* does not have to find every instance of required cooperation in the specific rules contained in a particular national law or derived from trade usages in the narrow sense. In this regard, the decision maker may rely on their abstract reasoning, as a result of the power of discretion granted by the standard of good faith. However, the exercise of abstract reasoning in a manner that severs the links between the standard and the realities of the case, as in the ICSID case between *Klöckner v. Cameroon*, resembles the activities of *amiable compositeurs* or arbitrators in equity, who exercise their authority to act *contra legem*, when, according to their sense of equity, the enforcement of the contract leads to an inequitable result.

The general preference of arbitrators for the application of standards can be observed in the application of both the applicable national law and the UNIDROIT Principles.¹⁷⁰⁷ This probably results from the fact that the general principles or standards allows for solutions better adapted to the particular circumstances of the case. However, in the application of the principle of standard of good faith to supplement the contract with various duties of cooperation, the decision maker applying *lex mercatoria* should constantly keep in mind the underlying bargain, purpose and nature of the contract through a contextual approach. In ICC Case No 9593, the arbitral tribunal supplemented the contract with an implied duty to cooperate on the part of the supplier, since the relevant exclusive distributorship agreements failed to deal with the contingency of the transitional period in the contractual relationship. The dispute arose from a number of exclusive distribution agreements concluded between an Ivorian distributor and a joint venture supplier of UK/Japanese origin. As a result of the distributor's failure to make payment punctually, the supplier decided to terminate the agreements. The distributor initiated arbitration proceedings, arguing that the defendant's termination of the agreements was unfounded and alleging the defendant's failure to perform its contractual obligations in good faith and general lack of cooperation. The contracts contained a choice of law clause in favor of Ivorian law. The arbitral tribunal stated that "Pursuant to Article 13(5) of the ICC Rules, the Arbitral Tribunal shall also take into account the provisions of the contract and the relevant trade usages. In doing so, the Arbitral Tribunal will pay particular attention to the specific nature of the Agreements and to the context within which they were entered into."¹⁷⁰⁸

¹⁷⁰⁵ Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 828

¹⁷⁰⁶ Derains, Yves, *Observations following ICC Award No. 1990, 1972*, *Journal du Droit International*, (1974), p. 897

¹⁷⁰⁷ ICC Award in Case No. 10346, December 2000, ICC International Court of Arbitration Bulletin, 12-2 (2001), at 108: the tribunal applying Columbian law as well as the UNIDROIT Principles, referred to the general provisions under Articles 1.7 and 5.1.3 of the UNIDROIT Principles, rather than Article 6.1.14 (Application for Public Permission) in dealing with the defendant's failure to perform the duties of cooperation in order to obtain the public registration, which was required for the enforceability of the contract.

¹⁷⁰⁸ ICC Award in Case No. 9593, December 1998, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 107

The tribunal referred to Article 1156 of the Ivorian Civil Code, which required the tribunal to look for the real intent of the parties and not only the literal wording of the agreements. The tribunal also stated that the custom to be taken into consideration by the arbitral tribunal within the framework of Article 1135 of the Ivorian Civil Code is to be found within the usages of international trade. The tribunal derived from Article 1134 (3) of the Ivorian Civil Code, which requires that contracts be performed in good faith, the obligation to cooperate in good faith to reach the common goals contractually agreed upon. Given that the Ivorian Civil Code was largely drawn from the French Civil Code, the tribunal cited the famous formula of French doctrine, which presents the contracts as a sort of microcosm, where each party must work towards a common purpose.¹⁷⁰⁹ According to the tribunal, the French courts have decided that good faith and loyalty oblige a party to a contract to facilitate the performance of its obligation by the other party on the basis of the identical text of Article 1134 (3) of the French Civil Code. The arbitral tribunal considered such obligation to cooperate in good faith in the performance of the contract, as a fundamental element of the usages of international trade applicable to this case and cited several ICC awards in support of this opinion. The arbitral tribunal also referred to Article 5.1.3 of the UNIDROIT Principles, as “a comparative study”, in order to confirm its conclusion that “[t]he obligation to cooperate in good faith in the performance of a contract [amounts] to a general principle applicable to international trade”.¹⁷¹⁰

On the basis of these considerations and the facts of the case, the arbitral tribunal found that, the relations between the parties required a close cooperation and an adaptation period, as they had decided to create a new structure in the frame of an already existing long term relationship, in which, the claimant had not scrupulously complied with its contractual obligations. Although the agreement authorized the defendant to terminate for “serious breach” as defined by the agreement and the tribunal was convinced that a number of the breaches relied upon by the defendant did take place, the tribunal interpreted the termination clause of the agreement to the effect that, when the parties entered into the agreement, their real intention, to which the tribunal had to give particular relevance pursuant to Article 1156 of the Ivorian Civil Code, was that, even if the claimant was in breach of his contractual obligations, many breaches, even repeated, would not be considered as serious breaches allowing termination before the expiry of a period of two years of adaptation period. The agreement also allowed the defendant to terminate the contract immediately in case of failure by the claimant to make any payment due to it by the due date. The tribunal held that the exercise of such a right was available only if the breach of claimant was indisputably established, if it was not caused by other breaches on the part of the defendant and if the defendant did not exercise its right abusively. The tribunal found that the defendant by its general behavior did not cooperate with the claimant in a way which would have allowed the claimant to strictly comply with all of its obligations. Thus, the tribunal considered that the claimant's delays as regards payments were not clearly established as the claimant's defaults, since they were caused, in part, by the defendant's behavior. The tribunal concluded that “where there was no certainty that Claimant was in breach of its obligations of payment, where the real intent of the parties was that no termination would take place before two years

¹⁷⁰⁹ This formula was also cited by an arbitral tribunal applying Egyptian law in Cairo Regional Centre for International Commercial Arbitration Final Award of 21 Dec. 1995, *Yearbook Commercial Arbitration*, 22 (1997), at 17-18

¹⁷¹⁰ ICC Award in Case No. 9593, December 1998, *ICC International Court of Arbitration Bulletin*, 10-2 (1999), at 108

of the life of the Agreements in most of the cases of breach and where Claimant's breaches were largely caused by Respondent's attitude and by the latter's breach of its duty to cooperate, the Arbitral Tribunal decides that the termination of the Agreements by Respondent was not justified and, therefore, abusive.”¹⁷¹¹

In an ad hoc award of 2001 rendered in Costa Rica, the case concerned an agreement between a French corporation and a Costa Rican corporation to participate together in a public contracting procedure for the construction and exclusive operation, for a ten-year period, of centers for technical revision of vehicles in Costa Rica. The French corporation had not joined the other party's appeal against the award of the project to a third party, as a result of which the Costa Rican corporation was unable to conclude the procedures. The Costa Rican corporation initiated the arbitral proceedings alleging the defendant's breach of the joint venture agreement. The parties had agreed that any dispute should be resolved “on the basis of good faith and fair usages and with regard to the most sound commercial practices and friendly terms”. The tribunal deemed itself enabled to apply UNIDROIT Principles on the basis of the consideration that “Not only national statutes and jurisprudence are applicable to this case, but also regulations of international trade that are essentially conformed by the principles and usages generally admitted in commerce which the parties agreed upon in the tenth clause of the letter of intent stating that they would act, amongst themselves, on the basis of good faith and proper customs and with regard to the most sound commercial practices and friendly terms.”¹⁷¹²

The ad hoc tribunal held that each party must act in a way that does not damage the other party and that parties must comply with the obligation of cooperation that modern doctrine derives from the principle of good faith, which must govern the performance of every contract. Additionally, the tribunal noted that ICC Case No 9593 had provided that, according to the UNIDROIT Principles, the usages of international trade require good faith in the fulfillment of contractual obligations. The tribunal stated that “The defendant's refusal to appeal constitutes conduct that is inconsistent with its previous participation in the Public Contracting Procedure along with the plaintiffs; procedure during which a relationship of trust had been generated between the parties in regards to the fulfilment of the letter of intentions and the joint venture agreement. The conduct shown by the defendant during its own performance of its contractual duties reveals the scope of its obligations; hence, this conduct prevented the defendant from taking a course of action inconsistent with it, such as refusing to participate in the appeal against the improper adjudication of the Contracting Procedure to a third party.”¹⁷¹³ Thus, the tribunal considered that, the French corporation had been in breach of its implied duties of cooperation, where the parties had failed to deal with the contingency of an appeal procedure in the contract. The tribunal held that a relationship of trust had been generated between the parties in regards to the fulfillment of the letter of intent and the joint venture agreement during the course of performance of contractual duties, which revealed the scope of implied obligations of the parties. The tribunal awarded damages for the loss of the opportunity of gaining the probable profits of the interrupted projects.

¹⁷¹¹ Ibid., at 107-109

¹⁷¹² Ad hoc Award (San José, Costa Rica), April 30, 2001, Costa Rican company vs. French company, Cited by Vargas, V. Pérez & D. Pérez Umana, *The UNIDROIT Principles of International Commercial Contracts in Costa Rican Arbitral Practice*, *Uniform Law Review*, (2006), at 181

¹⁷¹³ Ibid., at 182-183

In ICC Case No. 12127, the tribunal considered that the contractual clauses in a license agreement, which regulated the consequences of termination, survived the termination of the contract and, thus, extended the duration of the agreement thereby leading to the implication of a duty of cooperation on the basis of the principle of good faith even after the agreement was effectively terminated. The claimant, French licensor, and defendant, US licensee, entered into an exclusive license agreement covering the procedures, know-how and techniques to manufacture the product under the US patents, as well as the right to sell the product in the United States and Canada. The agreement provided that it was governed by the laws of France. After the termination of the contract, a research institute contacted a customer of the defendant, and wished to obtain samples in order to include the product in an important comparative study. The customer referred the institute to the defendant, but the latter did not respond to the institute. The institute then contacted another customer of the defendant, and the second customer provided samples of the product. In the arbitral proceedings, the claimant contended that it should have been informed by the defendant of the institute's requests for the purpose of the study, later publication of which showed the product performing poorly.¹⁷¹⁴

Although the contract did not expressly provide for a clause obliging the licensee to inform licensor of facts and circumstances pertinent to the trade mark and patent's protection, the tribunal believed that the defendant was effectively under such an obligation for two reasons. First, in the tribunal's opinion, such a clause is essential to any trade-mark and patent license agreement, and can as such be considered as an implied term of the contract. Secondly, the tribunal considered that such information obligation is a general consequence of Article 1134 of the French Civil Code, according to which contracts have to be performed in good faith. The tribunal observed that "case law and doctrine are well settled that good faith performance implies a certain degree of spontaneous co-operation between the parties" and "such cooperation imposes upon each party to inform the other party of any non-confidential information pertinent to the contract and useful to its interests."¹⁷¹⁵ The tribunal also pointed out that French case law does not limit such information obligation to the pre-contractual stage, but extends it to the whole life of the contract. According to the arbitral tribunal, the fact that the letters from the institute were received by the defendant after the contract's termination did not release respondent from its obligation to disclose them to claimant. The tribunal considered that the right granted to the defendant by the contract, to sell its inventory after termination, implied that the contractual obligations be also respected after termination and until the last inventory sales. Thus, at the moment the defendant received the institute letters, it was still bound to perform the contract in good faith, and the tribunal held that its failure to forward these letters to the claimant constituted a breach of the contract.¹⁷¹⁶

b. Costs of Cooperation

The decision maker supplementing the contract with duties of cooperation should respect the specific allocations agreed by the parties in the contract and their reasonable expectations in the context of a particular contractual equilibrium. Thus, the decision maker should assess the consequences of implication of a duty to cooperate on the basis of the reasonableness of the costs and the interests of both parties in the realization of contractual purpose, and not focus solely on imposing such duties on one party thereby disregarding the possible implication of

¹⁷¹⁴ ICC Award in Case No. 12127, 2003, Yearbook Commercial Arbitration Volume, 33 (2008), at 82-83

¹⁷¹⁵ *Ibid.*, at 93

¹⁷¹⁶ *Ibid.*, at 94

corresponding duties for the other party in the particular circumstances of the case. The decision maker may apportion the burden and costs of duty to cooperate between the parties if required by the circumstances of the case. It is observed that arbitrators consider the maintenance of contractual and financial equilibrium throughout the contractual relationship as essential, since without such equilibrium the contract becomes one based on speculation.¹⁷¹⁷

In ICC Case No 3779, the dispute concerned three sale agreements, between a Swiss seller and a Dutch buyer, according to which the merchandise coming from a Canadian factory was to be delivered to Rotterdam. However, only the first two contracts were signed by the parties and executed. The third contract was not signed and before shipment from Canada took place, it was cancelled by the buyer, who complained that the merchandise delivered under the first two contracts was not in accordance with the quality prescribed in the contract. It appeared that the goods were in accordance with the contractual requirements when analyzed under the North American method, but not when the European analytic method was used. The seller claimed indemnification in respect of the cancellation of the third contract. The sole arbitrator determined that Swiss law was applicable to the contract. He found that both parties acted in good faith. The seller had immediately declared his willingness to submit samples drawn by both parties to a test by a component laboratory to be chosen by both parties, and to accept cancellation of the remaining contracts, if analysis proved that the buyer's allegations had been well-founded. The buyer had also immediately reported quality problems, and restricted himself to refusing to give any forwarding-instructions or to receive the goods ordered, but not yet loaded on board.¹⁷¹⁸

The arbitrator noted that the dispute essentially arose from a misunderstanding. When the seller initially gave a description of the goods, no mention was made of a method of analysis. The buyer supposed that, since the description was given by a European firm, the European methods were to be applied, whereas, when the quality problems emerged, the seller announced the North American method of analyzing, which, according to him, is internationally accepted. The arbitrator stated that, although North American method is better known in the international industry concerned than a French method, it cannot be considered to be implicitly understood, at least, not on the European market. According to the arbitrator, the seller should have mentioned that the contractual description was to be interpreted according to the North American method. The arbitrator considered that, according to the traditional rule of interpretation, "in dubio contra proferentem", the seller was obliged to state clearly what obligations he was undertaking. On the other hand, the arbitrator noted that the buyer knew very well that goods were of Canadian origin, so that the error was also due to his negligence, for he should have asked about the meaning of the symbols used in the contractual description of the merchandise, of North American origin. The arbitrator thus examined "the dialectics between the right of being informed, and the obligation of informing oneself." The arbitrator held that the error of the buyer was due to a negligence shared with the claimant, but the North American method being more frequently used than the other methods, the negligence of the seller as to the information seemed less than that of the buyer.¹⁷¹⁹ The arbitrator stated that, in Swiss law, the erring party can ask for invalidation of the contract even if the error is due to his own negligence, but is obliged to pay compensation,

¹⁷¹⁷ Cremades, Bernardo M., Practitioners' Notebook: The Impact of International Arbitration on the Development of Business Law, *American Journal of Comparative Law*, 31 (1983), at 528

¹⁷¹⁸ ICC Award in Case No. 3779, *Yearbook Commercial Arbitration* (1984), at 127-128

¹⁷¹⁹ *Ibid.*, at 129-130

and this responsibility presupposes a fault on his part, due to his own negligence, such as the fact that the buyer did not sufficiently ask for information about the goods. The arbitrator also stated that Swiss law provides, in principle, that the erring party does not owe any indemnification to his co-contractor if the latter could have known the error, but adjudication of a reduced indemnification in the case of a joint fault appears to be justified and desirable. The arbitrator held that, “Taking into consideration the respective faults, it is equitable to adjudicate an indemnification reduced by two fifth, the [buyer] being responsible for 3/5 for the misunderstanding, and the [seller] for 2/5.”¹⁷²⁰

The principle of good faith and fair dealing in general and the duty to cooperate in particular require each party not to create or utilize a beneficial situation for himself or disadvantageous situation for the other party in contravention of the underlying purpose of the contract. In some arbitral cases, this implies a duty to keep other party informed as a specific instance of duty to cooperate in order to enable the performance of the contract and achieve its purpose. However, it is difficult to propose the existence of an established rule in the order of international commerce that provides an unqualified general duty to inform under the heading of cooperation between the parties, with the exception of the duty to give reasonable notice of termination, delay or defects.¹⁷²¹ In essence, obtaining information involves costs that are not expressly included in the contract price.¹⁷²² Under the transactions governed through legal uncertainty, the parties can usually be considered as being partners in a joint project and bound by a certain degree of loyalty on the basis of the principle of good faith and fair dealing under *lex mercatoria*. When the individual interests of parties diverge from their interests in the success of that joint project, the duty to cooperate could be implied on the basis that it furthers the successful completion of the contractual undertakings, provided that the costs of the duty are reasonable in the sense that, under a contextual approach, they are deemed to be covered by the underlying bargain according to the presumed intentions of the parties. The presumed intentions of the parties may require the decision maker to impose a duty of cooperation on the party that can perform this duty at minimal cost or to apportion the costs of cooperation between the parties by imposing duties of cooperation on both of the parties. Thus, a duty to inform arises if non-disclosure would impede or seriously affect the performance of the contract or an entitlement of one of the parties. On the basis of the particular circumstances of the case, this duty will be subject to the reasonableness of costs, the requirements of confidentiality and the corresponding duty of the other party to perform reasonable diligence in seeking out such information.

¹⁷²⁰ *Ibid.*, at 130

¹⁷²¹ See, e.g., *Agrostruct International, Inc. v. Iran State Cereals Organization*, Iran-U.S.C.T.R. 18 (1988 I), at 196 (the failure to give notice for delay and defects-in implementing a turnkey construction contract for a bakery plant-bars a claim for damages and delay penalties for being contrary to good faith); ICC Award in Case No. 5548, *Yearbook Commercial Arbitration* 16 (1991), at 81 (notice of defect to be remedied); ICC Award in Case No. 4975, *Yearbook Commercial Arbitration*, 14 (1989), at 133 (notice to terminate); ICSID award, *Société Ouest Africaine des Bétons Industriels (SOABI) v. Republic of Senegal*, *Yearbook Commercial Arbitration*, 17 (1992), para 46, at 58 (notice to terminate); *Teichmann, Inc. v. Hamadan Glass Company Iran-U.S.C.T.R.*, 13 (1986 IV), at 143 (notice of defects); *Component Builders, Inc. v. Iran*, Iran-U.S.C.T.R., 23 (1989 III), at 17-22, dissenting opinion, Ansari, at 90-96 (notice to terminate a building supply and construction agreement); *Development and Resources Corporation v. Iran*, Iran-U.S.C.T.R., 25 (1990 II), at 36 (required termination formalities).

¹⁷²² Nassar, Nagla, *Sanctity of Contracts Revisited : a Study in the Theory and Practice of Long-Term International Commercial Transactions*, M. Nijhoff, 1995, at 153

In line with this understanding, when supplementing the contract with a duty of cooperation, the decision maker applying *lex mercatoria* should take into account the equilibrium of contract and refrain from disturbing the bargain with the unreasonable costs of an implied duty to cooperate. This is particularly relevant to the consideration of the duty of renegotiation as an instance of the general duty to cooperate. In ICC Case No 2291, the arbitrator had to determine the price for transportation of a machine from France to Africa. The French transportation company claimed an increase of the transportation price since the quantity and weight of the pieces to be transported was larger than originally expected. The arbitrator, applying *lex mercatoria*, stated that any commercial transaction is founded on the balance of reciprocal performances and that to deny such principle would transform a commercial transaction into a hazardous and speculative contract. According to the arbitrator, it is a rule of *lex mercatoria* that the performances are balanced in financial terms, and that is why, in almost all international contracts, the price is established on the basis of the circumstances existing at the time of the conclusion of the contract, and it will vary according to the parameters that reflect changes in values of the different components of the product or performance.¹⁷²³ The arbitrator considered that as the contract must be interpreted in good faith, each party has the duty to behave in a manner that avoids causing prejudice to the other party, while the reasonable renegotiation being customary in international economic transactions.¹⁷²⁴ It is argued that the renegotiation of the contract is considered by the arbitrator as a natural consequence of the parties' obligation to cooperate.¹⁷²⁵ However, when arriving at that conclusion, the arbitrator took into account the adaptation clause providing for a price revision. The tribunal did not imply a duty to cooperate in the form of renegotiation in the case of changed circumstances, in a manner that would disturb the equilibrium of contract, but held that the parties have to display a normal and usual diligence in negotiations, which is reasonable for safeguarding their interests, particularly by trying not to make rushed and unreasonable offers, with a potential to surprise the co-contractor.¹⁷²⁶

Thus, the decision maker applying *lex mercatoria* should not consider that a mere change of circumstances implies a duty to renegotiate the contract, which is silent in that respect, solely on the basis of the idea that long-term contractual relationships require closer cooperation between the parties. In ICC Case No 2478, although the contract contained an adaptation arrangement providing an obligation to negotiate with a view to agreeing on measures to be taken in order to re-establish a contractual equilibrium in the event that the French franc or the U.S. dollar (the contract currencies) would be devalued or revaluated, the arbitral tribunal did not extend this arrangement to a duty to renegotiate in case of the fluctuations of prices on the world oil market, as the tribunal did not consider this arrangement as a price revision clause.¹⁷²⁷ In ICC Case No 2404, the arbitral tribunal stated that the principle *rebus sic stantibus* should be applied with care and prudence, especially if the intention of the parties has been clearly expressed in a contract. Since the parties to international commercial contracts are presumed to undertake their engagements with full knowledge, the absence of an adaptation clause in the contract to take account of the changed circumstances led the tribunal

¹⁷²³ ICC Award in Case No. 2291, *Journal du Droit International*, (1976), at 989

¹⁷²⁴ *Ibid.*, at 990

¹⁷²⁵ Bernardini, Piero. Is the Duty to Cooperate in Long-Term Contracts a Substantive Transnational Rule in International Commercial Arbitration?, in Emmanuel Gaillard (ed.), *Transnational Rules in International Commercial Arbitration*, ICC Publication No. 480/4, Paris 1993, at 140

¹⁷²⁶ ICC Award in Case No. 2291, *Journal du Droit International*, (1976), at 990

¹⁷²⁷ ICC Award in Case No. 2478, 1974, *Yearbook Commercial Arbitration*, 3 (1978), at 222

to reject the application of the principle *rebus sic stantibus*. The silence of the parties was interpreted as a decision by the parties to run a commercial risk.¹⁷²⁸

In an ad hoc arbitration case, a Yugoslav pipeline enterprise undertook to extend up to the Yugoslav-Hungarian border an oil pipeline that was to be built from a Yugoslav seaport and to transport crude oil from the Yugoslav seaport to the Hungarian border. The Hungarian state enterprise undertook to use, as oil importer, the services of the Yugoslav pipeline enterprise on a long term basis and to have the stipulated quantities of crude oil transported by the pipeline within stipulated time limits and for the stipulated fee. A dispute arose between the parties, and the Yugoslav pipeline enterprise brought a claim for penalties, since much smaller quantities of crude oil than stipulated were transported. As a defense the Hungarian state enterprise invoked change of circumstances because of the outbreak of the Iraq-Iran war, claiming that there was a general deterioration on the oil market, which resulted in a restriction of oil consumption and thereby also of transportation.¹⁷²⁹ The ad hoc arbitral tribunal considered the reasoning of the Swiss Federal Court, which held in a decision of September 18, 1981 that “In long-term contracts the parties must reckon with the fact that circumstances which existed at the time of contract formation can subsequently change. If they explicitly or obviously (*sinngemäß*) refrain from excluding the influence of such changes on their mutual contractual obligations, then it corresponds to the essence of the contract that it must be fulfilled the way it has been concluded. In this case, each party must basically bear the risks stemming from changed circumstances.” The tribunal considered that the shortage on the crude oil market and the rise in oil prices were foreseeable at the time of contracting. On the basis of the contractually established equilibrium between the parties, the tribunal concluded that it cannot supplement the contract with implied terms, which would let only one contracting party feel the consequences of changed circumstances.¹⁷³⁰

On the other hand, in ICC Case No 10346, the arbitral tribunal found, on the basis of the contract, the applicable national law and the UNIDROIT Principles, an implied duty of renegotiation, as an instance of cooperation between the parties, to revise their contract for obtaining the public registration, which was required for the enforceability of the contract. The claimant, a Colombian company, and the defendant, another Colombian company, entered into a contract, under which the claimant was to sell electrical energy to the defendant, so that the latter could ensure the public supply of electricity in a part of Colombia. However, the agreement was never performed as the contract was not registered with the Sistema de Información Comercial (SIC), and the claimant initiated arbitration proceedings against the defendant for breach of contract. The contract only made reference to the obligation to register in clause 18 when, in an impersonal way, it provided: “This contract shall be deemed to be perfected by the duly legalized signatures of the parties, but to be enforceable it requires registration with the SIC.”¹⁷³¹ The defendant contended that the contract was null and void for lack of registration. The contract contained a choice of law clause in favor of Colombian law, and the arbitral tribunal decided to apply Colombian law as well as the provisions of the contract and the relevant trade usages in accordance with Article 17.2 of the ICC Rules of Arbitration.

¹⁷²⁸ ICC Award in Case No. 2404, *Journal du Droit International*, (1976), at 995

¹⁷²⁹ Ad hoc award of July 6, 1983, *Yearbook Commercial Arbitration*, 9 (1984), at 69

¹⁷³⁰ *Ibid.*, at 70

¹⁷³¹ ICC Award in Case No. 10346, December 2000, *ICC International Court of Arbitration Bulletin*, 12-2 (2001), at 108

The tribunal observed that the final efficacy of the contract was subject to a condition whose performance depended on positive joint action by the parties, namely the amendment of the corresponding terms of the agreement, in view of the position taken by the director of the public registry. According to the tribunal, the registration was not an essential part or prerequisite of validity, nor even a procedure to publicize the contract, but rather, an administrative requirement for its enforcement. The tribunal interpreted the clause 18 of the contract to the effect that the registration was a joint task of the parties, in line with Article 871 of the Colombian Commercial Code and, “with the so-called “duty to collaborate” which is a rule of conduct that is clearly a “responsibility” which is discharged by the performance of the necessary acts, and whose omission, depending on the circumstances, may simply mean that the party concerned cannot attribute to the other party the adverse consequences of the omission and, therefore, claim breaches against that party which are only attributable to the party concerned itself.” The tribunal also referred to Article 5.1.3 of the UNIDROIT Principles, which provides the general principle of the duty of cooperation between the parties.¹⁷³² According to the tribunal, there was the unquestionable and clear duty, at the root of the relationship between the parties, in the first instance, by reason of their own interest, but at the same time by reason of a real obligation towards the other party, to do everything in their power to adjust the provisions of the contract to the requirements of the resolutions of the Energy and Gas Regulation Commission and the director of the SIC, in view of the fact that if this step was not taken, all possibility of the performance of the contract was blocked, giving rise to the obligation to make full compensation.¹⁷³³ The tribunal found that the claimant clearly tried to obtain registration of the contract in the SIC and did everything within its power, but the defendant had not performed the duty to collaborate that it was obliged to exercise jointly with the claimant in order to adjust the provisions of the contract to the requirements of the public authority thereby obtaining the registration of the contract.¹⁷³⁴

When there is a duty to negotiate, the arbitral tribunals generally hold that the parties are not obliged to agree, which would involve unreasonable costs on the part of the parties, but the negotiations must be conducted in good faith, particularly in a cooperative manner. In the Aminoil award, the tribunal stated with regard to a renegotiation clause that “The question here involved - one of those that are central to the present litigation - is a difficult one, known to all legal systems. An obligation to negotiate is not an obligation to agree. Yet the obligation to negotiate is not devoid of content, and when it exists within a well-defined juridical framework it can well involve fairly precise requirements.”¹⁷³⁵ In this regard, the tribunal stated later in the award that “the general principles that ought to be observed in carrying out an obligation to negotiate, - that is to say, good faith as properly to be understood,” require

¹⁷³² Ibid.

¹⁷³³ Ibid., at 109

¹⁷³⁴ Ibid. In particular, the tribunal noted that the defendant, “apart from agreeing to the request of the director of the SIC to take part in a meeting in order to analyse the obstacles to registration and to execute the Addendum No. 2, extending the “start date” of the contract, given that “the purchaser and the vendor require additional time over and above the start date to study the legal aspects of the contract”, took no steps to overcome the difficulties and there is no evidence in the proceedings of any proposal whatsoever other than the very dubious suggestion that it would be flexible in return for the unrestricted acceptance by [Claimant] that “the energy must be supplied at the measuring points at a voltage level of 110 kv, 66 kv and 13.8 kv”” and “none of [Defendant's] many officers and advisers showed any inclination towards an alternative solution, nor put forward any idea, nor prepared any counterproposal to the amendments suggested by [Claimant] in order to obtain the registration of the contract in the SIC”

¹⁷³⁵ Ad-Hoc-Award, Kuwait v. The American Independent Oil Company (AMINOIL), International Legal Materials, 21 (1982), at 1003-1004

“sustained upkeep of the negotiations over a period appropriate to the circumstances; awareness of the interests of the other party; and a persevering quest for an acceptable compromise.”¹⁷³⁶

In the *Wintershall v. Qatar* case, the ad hoc tribunal interpreted Qatar’s obligations of cooperation in the form of notification and negotiation under the Exploration and Production Sharing Agreement (EPSA), to the effect that they required an extension of the performance periods applicable to Wintershall to exercise its contractual rights. According to the EPSA, Wintershall obtained a 30-year exclusive right to explore, drill and produce petroleum in the Contract Area in 1976. Wintershall was required to relinquish 50% of the Contract Area after five years, and another 20% after eight years. If neither “Crude Oil in Commercial Quantities” nor “economically-utilizable non-associated Natural Gas” were found within eight years, Qatar was entitled to terminate the EPSA. If non-associated natural gas were discovered, Wintershall was permitted to produce it either pursuant to further contractual arrangements to be mutually agreed, or by exercising the “go it alone” option set out in EPSA. Wintershall never discovered crude oil in commercial quantities. However, because of a boundary dispute with Bahrain, the Emir instructed Wintershall not to drill in the Structure A area, which was regarded by Wintershall as the area most likely to contain crude oil. The Emir advised Wintershall that an extension of the exploration period would be studied by Qatar. In 1980, Wintershall notified Qatar of its discovery within the Contract Area of non-associated natural gas in substantial quantities, which it believed to be economical. Qatar and Wintershall considered several projects for the use of natural gas from the Contract Area as well as natural gas from an adjacent area in which a wholly-owned corporation of the Government of Qatar held the petroleum rights. No agreement was ever reached for projects in either of these areas. During the course of the discussions concerning those projects, Qatar sent Wintershall a telex informing that “the term of [EPSA] expired on 18th day of June 1985”, and “accordingly, this agreement is terminated with effect from this date.” However, neither party treated the EPSA expired or terminated. Wintershall did not relinquish any more of the Contract Area, paid the annual rental fee and continued to assert rights under the EPSA, while Qatar did not require relinquishment by Wintershall, accepted the annual rental fee and maintained that EPSA continued in existence. Wintershall, and other claimants with an interest in the EPSA, invoked the arbitration clause and claimed that Qatar breached the EPSA, by denying permission to explore the Structure A area, and by failing to agree on further contractual arrangements for the use of the non-associated natural gas.¹⁷³⁷

The tribunal determined that the law of Qatar was the governing substantive law. The tribunal found that there was neither breach by Qatar of the EPSA nor expropriation by Qatar of the claimants’ contractual rights and economic interest under the EPSA, including the claimants’ alleged loss of rights in respect of the Structure A area.¹⁷³⁸ According to the tribunal, the Government had no duty to agree to further contractual arrangements for the utilization of the non-associated natural gas in the Contract Area. The tribunal held that the duty to negotiate in good faith does not include an obligation on the part of the defendant to reach agreement with respect to the proposals made by the claimants and, to the extent that there was a duty to negotiate under Qatari law, the tribunal found that the refusal by the defendant to accept proposals by the claimants was made in good faith and justified by normal commercial

¹⁷³⁶ Ibid. at 1014

¹⁷³⁷ Ad Hoc Arbitral Tribunal: Partial Award and Final Award, February 5, and May 31, 1988, *Wintershall A. G. et al. v. The Government of Qatar*, International Legal Materials, 28 (1989), at 798-800

¹⁷³⁸ Ibid., at 803

practice.¹⁷³⁹ With respect to the natural gas project proposed for the adjacent area, the tribunal considered that claimants' rights under the EPSA did not extend outside the Contract Area, so that claimants' proposals were no more than mere offers, and their acceptance by Qatar was not required. According to the tribunal, the Government did not agree to any plan or project for the joint development of the adjacent area, and Qatar had no legal duty to unitize the area or to accept claimants' proposals for joint development.¹⁷⁴⁰

The tribunal considered that the refusal by the Government to permit exploration in Structure A Area was not a violation of the claimants' contractual rights under the EPSA, as the Government was expressly authorized to limit the claimants' operations under the EPSA. However, the government failed to advise the claimants of its dispute with Bahrain regarding this area prior to the signing of EPSA.¹⁷⁴¹ According to the tribunal, the application of the relinquishment provisions of the EPSA to the Structure A area under these conditions would result in an unduly harsh application of the EPSA provisions. The tribunal noted that, in effect, the Emir indicated that a harsh application of the relinquishment provisions would not at that time be insisted upon by the defendant. Thus, the tribunal declared that, in order for the claimants to exercise their rights under the EPSA in respect of this area, the relinquishment provisions would apply to Structure A area only from the date that the claimants are permitted to exploit this area under the EPSA provisions.¹⁷⁴² The tribunal also held that there was no misrepresentation by the defendant as to the Structure A area. However, in view of the defendant's failure to disclose to the claimants the details regarding its dispute with Bahrain regarding this area, the tribunal concluded that the parties did not intend to apply, and that it would be inequitable to interpret as applicable, the relinquishment provisions of the EPSA to the Structure A area until the claimants are permitted by the defendant to develop the Structure A area under the EPSA Provisions.¹⁷⁴³ The tribunal declared that the EPSA remained in force, as the defendant did not exercise its right to terminate and interpreted the telex of the Government as a notice that relinquishment was required rather than termination.¹⁷⁴⁴

The tribunal also declared that the relinquishment provisions of the EPSA were extended on the basis of its interpretation of the obligations of the parties under the EPSA. Referring to Article 49 of the Qatari Civil and Commercial Code, which provided that a contract shall be performed in accordance with its contents and in a manner consistent with the dictates of good faith, and it shall not only bind a contracting party to the content thereof, but it shall also extend to all its requirements in compliance with law, usage and equity depending on the nature of the obligation, the tribunal concluded that an appropriate and equitable interpretation of the Government's obligations under the EPSA required an extension of the performance periods applicable to the claimants if they exercise their "go it alone" option or their rights to exploit the Structure A area, as well as the defendant's obligations under the EPSA to cooperate in the exercise of these rights of the claimants.¹⁷⁴⁵ The tribunal determined that to

¹⁷³⁹ Ibid., at 814- 815

¹⁷⁴⁰ Ibid., at 815

¹⁷⁴¹ Ibid., at 816

¹⁷⁴² Ibid., at 817-818

¹⁷⁴³ Ibid., at 822

¹⁷⁴⁴ Ibid., at 822

¹⁷⁴⁵ Ibid., at 823

give effect to the intention of the parties that the claimants would be entitled to a realistic opportunity to exercise “go it alone” option, there must be a term in which those rights may be exercised, and concluded that the selection of an eight-year term was a reasonable application of the tribunal’s duty under Qatari law to construe the meaning of the contract in good faith.¹⁷⁴⁶ The tribunal considered that the claimants were justified in assuming that the conclusion of a joint venture in the Government’s area was probable. Although, such an assumption by the claimants would not require the Government to enter into a joint venture in the Government area, the failure of the Government effectively to terminate this possibility prevented the claimants from taking full advantage of the “go it alone” option and, accordingly, the tribunal felt that a proper and equitable interpretation of the “go it alone” option required the extension of the term for exercising this option.¹⁷⁴⁷ Thus, the tribunal held that, under the EPSA as it remained in force, the time for relinquishment of the 50 percent of the Contract Area still held by the claimants, if not in production, was extended to eight years from the date of the final award for the purpose of permitting the exercise by the claimants of their “go it alone” option, and that, if this option is exercised by the claimants, both the claimants and the defendant should perform their obligations as provided in the EPSA in good faith in accordance with Article 49 of the Qatari Code.¹⁷⁴⁸

In his separate opinion, Ian Brownlie, a member of the tribunal, did not consider that the remedial conclusions in the decision of the Tribunal in relation to Structure A had an adequate legal basis.¹⁷⁴⁹ He noted that the approach to remedies adopted by the tribunal derived from the conclusion that the relinquishment provisions of the EPSA applied to Structure A only from the date the claimants were permitted to exploit this area under the EPSA provisions. He agreed with the conclusion, but only on the basis of the waiver by the conduct of the Government of the literal application of the relinquishment provisions of the EPSA. He did not agree with the proposition of the majority that the Government was under an obligation to inform Wintershall about the disputes concerning the Structure A area, by referring to the risk allocation agreed by the parties and the corresponding obligation of Wintershall to perform reasonable diligence in seeking out information. He stated that “Given the reasonably clear provisions of [the EPSA], the Government was not placed under a duty to inform the claimants about disputes. It is a matter for the appreciation of the Government whether to exercise the power to lay down operating limits within the Contract Area. In any event, the evidence shows that the Government made no effort to conceal the facts and, further, that the

¹⁷⁴⁶ Ibid., at 824: The tribunal considered that for crude oil discoveries the claimants were to have four years after the last date for the discovery of crude oil to commence production and relinquish non-producing area, and for non-associated natural gas discoveries, an initial four-year period would be required to determine whether the gas could be utilized economically. According to the tribunal, the combination of these two four-year period and the adjustment for a period commencing with the final award rather than the Effective Date of the EPSA gave effect most completely to the parties’ intentions under the EPSA that the claimants have a meaningful opportunity to “go it alone,” but that relinquishment be required at some reasonable time if that opportunity were not exercised.

¹⁷⁴⁷ Ibid., at 825

¹⁷⁴⁸ The tribunal also declared that any extension in performance periods stipulated in other provisions or the EPSA required to make meaningful the extensions above provided would be made, including the extension of the term of the EPSA for eight years if the claimants exercise their “go it alone” option and an extension of such term to eighteen years from the date the claimants are required to relinquish non-producing areas in respect of Structure A. Moreover, the Government’s right to terminate the provisions of the EPSA, relating to operations in the structure A area, were declared to run for eight years from the time claimants are permitted to develop the Structure A area under the EPSA’s provisions rather than from the Effective Date. Ibid., at 806

¹⁷⁴⁹ Ibid., at 829

material facts could have been discovered by means of a very simple process of inquiry and research.”¹⁷⁵⁰ Thus, he concluded that “the decision of the Tribunal that the relinquishment provisions of the EPSA apply to Structure A ‘only from the date the claimants are permitted to exploit this area under the EPSA provisions’ is not supportable on the basis of the application of the EPSA and therefore can be justified exclusively on the basis of the conduct of the Government in not seeking to apply the relinquishment provisions in respect of structure A.”¹⁷⁵¹ In response, other members of the tribunal stated that “Professor Brownlie’s interpretation of ... the EPSA is inequitable, for under his own reasoning, any reservation by the Respondent ... could be applied at any point in time and, in effect, negate the entire agreement; whereas, in our opinion, if in fact the Government exercised its discretion not to inform claimants about disputes, the Tribunal could not in all equity at a later date apply the relinquishment provisions of EPSA strictly.”¹⁷⁵²

Professor Brownlie also noted that “The date at which the dispute affecting Structure A will be resolved is unknown, and it is common experience that disputes concerning title may take many years to settle.... [and] the remedy proposed would present the very elements of uncertainty and complication”. He expressed his opinion that “the appropriate remedy in accordance with the provisions of Articles 86 and 99 of the Qatari code would be the payment of equitable compensation”.¹⁷⁵³ Other members of the tribunal stated that, as the value of the claimants’ rights under the EPSA was dependent on the discovery of oil in the Structure A area, specific performance would be a more equitable remedy than the equitable compensation, which would presumably assume such discovery. They pointed out that should the tribunal order payment, such payment, dependent as it would be on a finding of oil, would be an unjust enrichment in good faith of the creditor. The majority indicated that both parties could elect to value at the present time this right, and reach a settlement, appropriate under the circumstances, but if the claimants did not have the right in the alternative to require specific performance, a cash valuation at this time would not reflect the true value of the claimants’ rights under the EPSA in the Structure A area.¹⁷⁵⁴

It appears from the facts stated in the award that under the specific allocations of contractual rights, obligations and risks agreed by the parties, the Government was entitled to limit Wintershall’s operations under the EPSA, Wintershall was permitted to produce natural gas in the Contract Area either pursuant to further contractual arrangements to be mutually agreed, or by exercising the “go it alone” option, the Government was under no obligation to inform Wintershall of disputes concerning Structure A area, and the relevant information was fairly accessible for Wintershall. In this context, the tribunal decided to extend the relinquishment periods of the EPSA, on the grounds that the failure of the Government to inform Wintershall of territorial disputes prevented Wintershall from exercising its rights under the EPSA in respect of Structure A area, and the failure of the Government effectively to terminate the negotiations relating to the natural gas project prevented the claimants from taking full advantage of the “go it alone” option.

¹⁷⁵⁰ Ibid., at 830

¹⁷⁵¹ Ibid., at 831

¹⁷⁵² Ibid., at 832

¹⁷⁵³ Ibid.

¹⁷⁵⁴ Ibid., at 833

The Government's subsequent conduct, namely the statements and the general treatment of the agreement as effective even if it was terminated, created the expectation of Wintershall about the possible extensions in the exploration periods in relation to Structure A area due to the territorial dispute. By its subsequent conduct, the Government can be considered as having undertaken to cooperate with Wintershall through further negotiations in finding a solution with regard to the exploitation of Structure A area with Wintershall. However, as acknowledged by the tribunal, the Government cannot be considered as in breach of its obligation to negotiate relating to a joint venture for the use of natural gas from the Contract Area. In fact, Wintershall was prevented from taking full advantage of the "go it alone" option as a result of its own choice under the EPSA, which permitted Wintershall to produce either pursuant to further contractual arrangements to be mutually agreed, or by exercising the "go it alone" option. Thus, it seems unclear how the Government was able to breach the EPSA, while complying with its duty to negotiate in good faith without being obliged to agree, merely by failing to terminate the negotiations, which were initiated as a result of Wintershall's choice and not the Government's. Apparently, the tribunal, merely on the basis of abstract considerations of equity, implied a residual obligation for the Government to terminate those negotiations after an uncertain amount of time, as an element of its duty of negotiation, to enable Wintershall to exercise its "go it alone" option.

Under its reasoning, the tribunal felt itself competent to substantially adjust the terms of the contract between the parties through equitable considerations, and its conclusions resembled an estimate of the decision maker as to an agreement that the parties would have reached had they renegotiated the contract to find an acceptable solution for Structure A area, and for extending the contractual periods to entitle Wintershall to a realistic opportunity to exercise "go it alone" option in relation to the natural gas project. The tribunal's conclusions could have more accurately reflected the reasonable expectations of the parties, had it ruled that the Government was only in breach of a duty to negotiate, which arose from its subsequent conduct, to find an acceptable solution for Structure A area. Subsequently, rather than imposing the speculative outcome of such negotiations that had not taken place on the parties through specific performance on the basis of the principle of good faith under Qatari law, the tribunal could have held that the Government failed to perform its duty to negotiate arising from its subsequent conduct due to its delay in initiating those negotiations, and thus became liable for compensating the damages of Wintershall. Given that the Government was not bound to agree to the extension of exploration or relinquishment periods, the order of specific performance in the form of extending those periods seems inappropriate, since it forced the tribunal to indirectly yet actively to restructure the agreement in contravention to the idea of reasonableness of the costs of implied duties of cooperation, which should have been determined through a contextual approach that takes into account the underlying bargain and the specific contractual rights, obligations and risk allocations.

3. Concluding Remarks

The general idea underlying the duty of each party to cooperate in the performance of the contract, which is most strongly asserted in the national legal systems of the civil law countries, is that an individual who engages in a contractual relationship must deal with its partner in a frank and loyal manner, as required by the principle of good faith. Similarly, under *lex mercatoria*, the conditions and degree of cooperation between the parties are determined on the basis of the basic principle good faith and fair dealing. However, given the significance of the parties' knowledge of particular circumstances of time and place in the order of international commerce, which is given effect to by the basic principles of freedom of

contract and *pacta sunt servanda*, the implication of duties of cooperation under the basic principle of good faith and fair dealing should not disregard the specific contractual rights and obligations, as articulated by the parties, which indicate the limits and allocation of costs of cooperation that is required by residual rights and obligations according to the reasonable expectations of the parties to a particular contract.

The duty to cooperate under *lex mercatoria* appears as a general implied term covering many instances of good faith duties, enabling the decision maker to exercise an abstract reasoning that forms the basis of his specialized consolidations about the required cooperative behavior of parties in a particular case. This general duty to cooperate may be specified as the duty to inform the other party at various events or stages of the contract, the duty to take measures in order to prevent or limit the effects of an event, and to mitigate any loss which may be caused by it, the duty to negotiate with the other party in good faith in order to adapt the contract to certain circumstances, the duty to allow the other party to check books on which payments must be computed, the duty to obtain certain authorizations, duty to keep certain information confidential, the duty not to compete with the contractual partner or solicit its employees. Those specific duties mainly arise from the abstract considerations of the closer confidence generated between the parties throughout the contractual relationship, the successful performance of contractual obligations, and the purpose of the contract.

In supplementing the contract with duties of cooperation, the decision maker applying *lex mercatoria* should adopt a contextual approach in evaluating the required behavior from the parties to a particular contract in order not to disturb the contractual equilibrium. The supplementing rule must enable the correspondence of expectations of the parties under the circumstances, and the costs of cooperation required by that rule must be reasonable and appropriate for the underlying bargain, purpose and nature of the transaction. When the parties may not be able to provide contractual clauses for each instance of required cooperation, the decision maker at the enforcement stage deals with the resulting legal uncertainty by supplementing the contract with such duties to cooperate that allocate the residual obligations in accordance with the underlying bargain and the established rules discovered through the basic principle of good faith and fair dealing. Under *lex mercatoria*, the knowledge of the established rules indicating the required cooperation is brought to bear on the allocational *ex post* decision, given that the principle of good faith and fair dealing ultimately relates to the capacity of the contracting parties to adapt their conduct both to the particular facts which they know and to other facts they are presumed to know tacitly through abstractions. The principle of good faith and fair dealing requires the *ex post* decision maker to mentally reconstruct this tacit knowledge of the parties through a contextual approach and to tell them what ought to have guided their expectations by revealing the established rules of cooperation in the particular circumstances which they ought to have known and which become applicable as a result of the conclusion of their particular contract.

Such tacit knowledge can convert incomplete knowledge, which inheres in the facts of the case and the articulated rules, into a workable format. On that basis, the decision maker will be able to determine the degree of cooperation expected from each of the parties and the content of the required cooperative behavior in accordance with their reasonable expectations. However, the decision maker applying *lex mercatoria* should not solely rely on the abstract concept of good faith in supplementing the contract with various duties of cooperation, in a manner similar to an amiable composituer or arbitrator in equity, which runs the risk of exceeding his scope of delegation in the control of legal uncertainty. Under *lex mercatoria*, the allocation of residual contractual obligations under the considerations of the costs of

cooperation may lead to the impression of “splitting the difference” in some cases, where the extent of a party’s duty of cooperation is limited by the other’s corresponding duty of diligence. However, what motivates the abstract reasoning under *lex mercatoria* will not be the illusory aim of satisfying both parties by giving something to both parties, but the concern for accuracy in giving effect to the reasonable expectations of the parties by the decision maker’s exercise of equity *infra legem* in the residual allocations of risks and obligations, as authorized by the articulated or established rules in the particular case.

ii. Duty to Achieve a Certain Result and Duty of Best Efforts

Under *lex mercatoria*, the issues regarding the liability for non-performance, such as conditions of liability and burden of proof, depend on the articulated rules as agreed by the parties in their contractual clauses and the rules of a national law chosen by the parties to govern the substance of the dispute, pursuant to the basic principles of *pacta sunt servanda* and freedom of contract. However, the way the parties articulate the contractual obligations in the contract may override the default rules of the chosen national law as to the contractual liability. The interpretation of contract may indicate the regime of contractual liability in the particular case. The decision maker should look into the common intentions of the parties with the aid of, where necessary, extrinsic factors and interpretative presumptions in order to ascertain the intensity of contractual obligations, as articulated by the parties, pursuant to the basic principle of good faith and fair dealing. These considerations will lead the decision maker either to determine that the obligation in question is an undertaking to achieve a certain result, or an undertaking of best efforts, and such a characterization may resolve many questions relating to liability for non-performance. The same considerations are also relevant to the supplementation of the contract with individualized terms in the ascertainment of the content of contract, which precede the application of the default rules provided for an internal order of an organization, even if the supplementation of the contract with such terms is to be made on the basis of those default rules. In supplementing the contract with individualized terms under *lex mercatoria*, the decision maker should consider the intensity of the residual contractual obligations through a contextual approach. This approach enables the decision maker to determine the conditions of contractual liability as well as the burden of proof under *lex mercatoria*, in accordance with the reasonable expectations of the parties.

1. Sources of Abstractions

a. National Laws

The general assumption under common law systems is that there is no requirement of fault for establishing contractual liability. Thus, in England, it was held that “in relation to a claim for damages for breach of contract it is, in general, immaterial why the defendant failed to fulfill his obligations and certainly no reference to plead that he had done his best.”¹⁷⁵⁵ Similarly, in the US, there is no reference to fault in the definition of breach given in Section 235 (2) of the Restatement Second Contracts, which provides that “When performance of a duty under a contract is due any non-performance is a breach.” It is stated that the US contract law is, “in its essential design, a law of strict liability, and the accompanying system of remedies operates without regard to fault.”¹⁷⁵⁶

As common law considers the contract predominantly as a means for risk allocation, the contractual liability arises where, under the contract, a party has taken the risk of certain events, and the relevant risk materializes, even if those events are beyond his control and occur without his fault. Nonetheless, the liability under common law is not absolute but only strict. It does not depend on fault, but it is subject to the doctrine of supervening impossibility or frustration.¹⁷⁵⁷ Moreover, this general principle of strict liability is subject to significant

¹⁷⁵⁵ *Raineri v. Miles* [1981] AC 1050, 1086

¹⁷⁵⁶ Farnsworth E.A., *Farnsworth on Contracts*, Aspen Publishers, 3rd ed., 2004, at 195–96

¹⁷⁵⁷ Treitel, G. H, *Fault in the Common Law of Contract*, in Maarten Bos & Ian Brownlie (eds.) *Liber amicorum for the Rt. Hon. Lord Wilberforce*, Oxford University Press, 1987, at 192

exceptions, in which fault becomes an element of contractual liability. For instance, the party is only under a duty of diligence, when he has to make arrangements or to obtain an approval in order to bring about the occurrence of a condition, on which the principal obligations depend. In these cases, the party under obligation is not liable if, in spite of making reasonable efforts, he fails to bring about the specified event.¹⁷⁵⁸

Another exception to the strict liability regime under common law arises in the field of the contracts for the provision of services where, both strict liability and liability based on fault are recognized. For instance, the Supreme Court of Minnesota held that “Architects, doctors, engineers, attorneys, and others deal in somewhat inexact sciences and are continually called upon to exercise their skilled judgment in order to anticipate and provide for random factors which are incapable of precise measurement. The indeterminable nature of these factors makes it impossible for professional service people to gauge them with complete accuracy in every instance Because of the inescapable possibility of error which inheres in these services, the law has traditionally required, not perfect results, but rather the exercise of that skill and judgment which can reasonably be expected from similarly situated professionals.”¹⁷⁵⁹ On the other hand, the Supreme Court of Kansas pointed out that the “work performed by architects and engineers is an exact science; that performed by doctors and lawyers is not,” so one “who contracts with an architect or engineer for a building of a certain size and elevation has a right to expect an exact result.”¹⁷⁶⁰

In English law, Section 13 of the Supply of Goods and Services Act 1982 provides that a person who supplies a service in the course of a business impliedly undertakes to carry out the service with reasonable care and skill. For instance, the standard for construction contracts with regard to the contractor’s obligation of carrying out of the work is one of care.¹⁷⁶¹ Mainly, the contractor’s obligation is to execute and complete the works and remedy any defects therein, in conformity with the provisions of the contract. As far as this obligation relates to the supervision of the supply of works and materials by others, the contractor is expected to exercise a reasonable degree of professional care and skill. However, Section 16 (3) (a) provides that nothing in this part of the Act prejudices any rule of law which imposes on the supplier of services a duty stricter than that imposed by Section 13. Under common law, if the contractor undertakes obligations relating to the design of the works, the standard of liability becomes strict. The expectation of the parties in such cases is that the contractor’s design will serve the agreed or contemplated purpose, not merely that he will take reasonable care to do so. In general, where the other party makes known the result that he desires the service to achieve, there is an implied warranty under English law that the services are of such nature that they might reasonably be expected to achieve the result. This is strict liability, since the other party bargains not for skill but for an end-result, and the duty to achieve that result is not performed merely by exercising due care and skill.¹⁷⁶²

Under the contractual liability regime of common law systems, the party under an obligation to perform is, in principle, considered as guaranteeing the result and has to achieve the result

¹⁷⁵⁸ Ibid., at 208

¹⁷⁵⁹ Mounds View v. Walijarvi, 263 N.W.2d 420, 424 (Minn. 1978)

¹⁷⁶⁰ Tamarac Dev. Co. v. Delameter, Freund & Assocs., 675 P.2d 361, 365 (Kan. 1984).

¹⁷⁶¹ Treitel, G. H, Fault in the Common Law of Contract, in Maarten Bos & Ian Brownlie (eds.) *Liber amicorum for the Rt. Hon. Lord Wilberforce*, Oxford University Press, 1987, at 197

¹⁷⁶² Ibid., at 200

of such performance. Such a party may protect himself from the strict liability regime by expressly contracting “best efforts” clauses. In the introductory note to Chapter 11 of Restatement Second Contracts, it is stated that “Contract liability is strict liability. It is an accepted maxim that *pacta sunt servanda*, contracts are to be kept. The obligor is therefore liable in damages for breach of contract even if he is without fault... The obligor who does not wish to undertake so extensive an obligation may contract for a lesser one by using one of a variety of common clauses: he may agree only to use his “best efforts”.”¹⁷⁶³ The contracting practice in common law jurisdictions reflects an attempt of drafters to expressly regulate the element of fault in establishing contractual liability through “best effort” clauses and their variants thereby broadening the scope of fault under the default liability regime.

In both England and the US, there are various judicial decisions in relation to the concept of “best efforts” and its variants: the tendency being to prefer “best endeavors” in England and “best efforts” in the US.¹⁷⁶⁴ Under common law, although the judges traditionally start their examination of the meaning of a word or phrase with their objective and natural meaning, they have not been able to use such a literal approach without difficulty in the cases of “best endeavors”.¹⁷⁶⁵ This is mainly because of the uncertain nature of the standard, which was criticized by Goff J. in the case *Bower v Bantam Investments Ltd.*, who stated that, “I ask myself, could anything be less specific or more uncertain? There is absolutely no criterion by which best endeavors and practicability are to be judged.”¹⁷⁶⁶

Under English law, the leading authority with regard to “best endeavors” clauses is the decision of *Sheffield District Railway Co. v Great Central Railway Co.* from 1911. The decision reflects the general attitude of courts to adopt a literal approach as far as possible, and to consider the promisor’s commercial interests in determining the limits of the duty. In *Sheffield District Railway Co. v Great Central Railway Co.*, the court had to consider an agreement that required Great Central Railway Company to use their best endeavors to develop the through and local traffic of Sheffield Railway, which it was alleged that they had failed to do. The court stated that “We think “best endeavors” means what the words say; they do not mean second-best endeavors. We quite agree with the argument ... that they cannot be construed to mean that the Great Central must give half or any specific proportion of its trade to the Sheffield District. They do not mean that the Great Central must so conduct its business as to offend its traders and drive them to competing routes. They do not mean that the limits of reason must be overstepped with regard to the cost of the service; but short of these qualifications the words mean that the Great Central Company must, broadly speaking, leave no stone unturned to develop traffic on the Sheffield District line.”¹⁷⁶⁷

In the case of *IBM United Kingdom Ltd v Rockware Glass Ltd*, the contract contained a clause requiring the purchaser to use its best endeavors to obtain planning permission. Buckley L.J. from the Court of Appeal stated that “in the absence of any context indicating to the contrary, this should be understood to mean that the purchaser is to do all he reasonably can to ensure that the planning permission is granted. If it were refused by the Local Planning

¹⁷⁶³ Restatement (Second) of Contracts ch. 11, introductory note (1981).

¹⁷⁶⁴ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 208

¹⁷⁶⁵ Varcoe-Cocks, M.D., *Best Endeavours*, *The Law Society’s Gazette*, (1986), at 1992

¹⁷⁶⁶ [1972] 3 All ER 349 at 355

¹⁷⁶⁷ (1911) 27 TLR 451

Authority, and if an appeal to the Secretary of State would have a reasonable chance of success, it could not, in my opinion, be said that he had "used his best endeavors" to obtain the planning permission if he failed to appeal . . . I cannot find . . . any context which satisfies me that the words "use its best endeavors to obtain consent" could be construed otherwise than in accordance with what I take to be their clear, primary and natural meaning."¹⁷⁶⁸ In *Midland Land Reclamation Ltd v Warren Energy Ltd*, Bowsher J., delivering the judgment, held that the "best endeavors" obligation was not the next best thing to an absolute obligation or guarantee, but it "must at least be construed in the light of the art as it developed from time to time during the life of the contract". He stated that "To be satisfied of a breach of a "best endeavours" clause by one party or the other, I would wish to hear evidence that in the light of the knowledge available at the time of the alleged default the party alleged to be in default was culpable."¹⁷⁶⁹

Under a literal interpretation, the difference in language of the clauses suggests that the terms "reasonable endeavors" and "best endeavors" should have different meanings. However, in the case law of England, the difference is not perfectly clear as the decided cases suggest that it is simply a matter of degree, in the sense of the extent or number of the measures that have to be attempted by the party undertaking the obligations of such endeavors. In *Overseas Buyers Ltd v Granadex SA*, Mustill J. was doubtful that there was a difference between reasonable endeavors and best endeavors. He observed that "Perhaps the words "best endeavors" in a statute or contract mean something different from doing all that can reasonably be expected -- although I cannot think what the difference might be..."¹⁷⁷⁰ In *Pips (Leisure Productions) Ltd v Walton*, the distinction between reasonable and best endeavors was also unclear in the statement that "I would construe a contract by the parties to 'use their best endeavors' to complete a purchase by a given date to mean what it says. 'Best endeavors' are something less than efforts which go beyond the bounds of reason, but are considerably more than casual and intermittent activities. There must at least be the doing of all that reasonable persons reasonably could do in the circumstances."¹⁷⁷¹ On the other hand, Rougier J., in *UBH (Mechanical Services) v Standard Life*, appeared to consider that an obligation to use reasonable endeavors was less stringent than an obligation to use best endeavors and stated "that the phrase "all reasonable endeavors" probably lies somewhere between the two, implying something more than "reasonable" but less than "best" endeavors."¹⁷⁷² Similarly, Kim Lewison QC, sitting as a Deputy High Court Judge, in *Jolley v Carmel Limited*, recognized that there was a spectrum of varying obligations where best and reasonable endeavors are at opposite ends, and "all reasonable endeavors" at somewhere in the middle.¹⁷⁷³ More recently, in *Yewbelle v London Green Developments*, it was held that the obligation to use all reasonable endeavors required the party to go on using reasonable endeavors until the point had been reached when all reasonable endeavors have been exhausted, and to go on would be mere repetition, but the party was not required to sacrifice its own commercial interests.¹⁷⁷⁴

¹⁷⁶⁸ *IBM United Kingdom Ltd v Rockware Glass Ltd* [1980] FSR 335

¹⁷⁶⁹ *Midland Land Reclamation Ltd, Leicestershire CC v. Warren Energy Ltd* [1997] EWHC TCC 375

¹⁷⁷⁰ [1980] 2 Lloyd's Rep 608

¹⁷⁷¹ (1980) 43 P & CR 415

¹⁷⁷² *UBH (Mechanical Services) Ltd v Standard Life Assurance Company*, *The Times*, 13 November 1986).

¹⁷⁷³ *Jolley v Carmel Limited* [2000] 2 EGLR 154

¹⁷⁷⁴ *Yewbelle v London Green Developments* [2006] EWHC 3122 (Ch); *Yewbelle Ltd v London Green Developments Ltd & Anor* [2007] EWCA Civ 475 (23 May 2007)

In the case of *Rhodia International Holdings Ltd v Huntsman International LLC*, Rhodia had agreed to sell a chemical manufacturing business to a subsidiary of Huntsman. The sale agreement contained provisions governing the manner in which the parties agreed to transfer and novate a number of contracts from the seller to the purchaser. The agreement provided that both parties were obliged to use reasonable endeavors to obtain the consent of any third parties to the novation of their contracts to Huntsman, that Huntsman would supply to those third parties such information reasonably requested, including information about the financial position of its group, and that Huntsman would provide a parent company guarantee if reasonably requested by those third parties. One of the contracts to be transferred was an energy supply contract that Rhodia was a party to with Cogen. Pending consent, Cogen raised concerns over the financial position of Huntsman's subsidiary and sought a parent guarantee from Huntsman. Huntsman refused to give the guarantee and gave notice to Rhodia that the relevant agreement was to be excluded from the sale and purchase of the business. Julian Flaux QC, sitting as a Deputy High Court Judge, considered that, “where the contract actually specifies certain steps have to be taken (as here the provision of a direct covenant if so required) as part of the exercise of reasonable endeavors, those steps will have to be taken, even if that could on one view be said to involve the sacrificing of a party's commercial interests”.¹⁷⁷⁵ Thus, he held that Huntsman was in breach of its obligations to use its reasonable endeavors to obtain the consent of Cogen, even if giving the guarantee would be sacrificing its own commercial interests. Although not relevant to the actual decision in the case, Julian Flaux QC also commented upon the difference between best and reasonable endeavors. He held that, “in so far as it was necessary to decide the point,... an obligation to use reasonable endeavors is less stringent than one to use best endeavors.” He rejected the argument that they mean the same thing and stated that “As a matter of language and business common sense, untrammelled by authority, one would surely conclude that they did not. This is because there may be a number of reasonable courses which could be taken in a given situation to achieve a particular aim. An obligation to use reasonable endeavors to achieve the aim probably only requires a party to take one reasonable course, not all of them, whereas an obligation to use best endeavors probably requires a party to take all the reasonable courses he can.” He also doubted that an obligation to use “all reasonable endeavors” was any different to an obligation to use “best endeavors”, and stated that “In that context, it may well be that an obligation to use all reasonable endeavors equates with using best endeavors and it seems to me that is essentially what Mustill J is saying in the *Overseas Buyers* case.”¹⁷⁷⁶

Under common law, the duty of reasonable endeavors has also been considered by the Privy Council in supplementing the contract with implied terms in the case of *Queensland Electricity Generating Board v New Hope Collieries Pty Ltd*.¹⁷⁷⁷ The case concerned a 15-year coal supply contract between the Collieries and the Electricity Board. The price was agreed for the first 5 years with the agreement containing base prices, which were adjustable by reference to “escalation” and “price variation” provisions. For sales and purchases after the first 5 years, the general terms of the agreement were to continue but the base price and the price variation provisions were to be agreed by the parties. The agreement contained a comprehensive arbitration clause for the resolution of disputes or differences. It was argued by the Electricity Board that, after the first 5 years, the agreement constituted an

¹⁷⁷⁵ *Rhodia International Holdings Ltd v Huntsman International LLC* [2007] EWHC 292 (Comm)

¹⁷⁷⁶ *Rhodia International Holdings Ltd v Huntsman International LLC* [2007] EWHC 292 (Comm)

¹⁷⁷⁷ [1989] 1 Lloyd's Rep 205.

unenforceable “agreement to agree”. The argument was rejected by the Privy Council. In delivering the opinion of the Privy Council, Sir Robin Cooke noted that the terms of the agreement indicated that it was intended by the parties to have legal effect for more than the first 5 years. He stated that “What other reasons could there be for making such elaborate provisions, emphasizing its long-term nature? At the present day in cases where the parties have agreed on an arbitration or valuation clause in wide enough terms, the courts accord full weight to their manifest intention to create continuing legal relations. Arguments invoking alleged uncertainty, or alleged inadequacy in the machinery available to the courts for making contractual rights effective, exert minimal attraction... In accordance with the approach adopted in those cases, their Lordships have no doubt that here, by the agreement, the parties undertook implied primary obligations to make reasonable endeavors to agree on terms of supply beyond the initial five-year period and, failing agreement and upon proper notice, to do everything reasonably necessary to procure the appointment of an arbitrator. Further, it is implicit in a commercial agreement of this kind that the terms of the new price structure are to be fair and reasonable as between the parties.”¹⁷⁷⁸

This decision seems difficult to reconcile with the decision of the House of Lords in *Walford v. Miles*, which refused to imply a term that the parties would negotiate in good faith.¹⁷⁷⁹ The difference between an obligation to use “reasonable endeavors” to reach an agreement and an obligation to negotiate in good faith is not clear and the decision in *Queensland Electricity* was not mentioned in *Walford*. Nevertheless, the House of Lords stated in *Walford* decision that “The reason why an agreement to negotiate, like an agreement to agree, is unenforceable is simply because it lacks the necessary certainty. The same does not apply to an agreement to use best endeavors.”¹⁷⁸⁰ In the case *Little v Courage Ltd*, the Court of Appeal attempted to clarify this issue.¹⁷⁸¹ Millett LJ, who delivered the judgment of the Court, stated that unlike some systems of law, English law does not recognize a pre-contractual duty to negotiate in good faith, and will neither enforce such duty when it is expressly agreed nor imply it when it is not.¹⁷⁸² He pointed out that, in *Walford* decision, the reference to sufficient certainty in relation to best endeavors was too loosely expressed. He held that “An undertaking to use one’s best endeavors to obtain planning permission or an export license is sufficiently certain and is capable of being enforced: an undertaking to use one’s best endeavors to agree, however, is no different from an undertaking to agree, to try to agree, or to negotiate with a view to reaching agreement; all are equally uncertain and incapable of giving rise to an enforceable legal obligation.”¹⁷⁸³ Thus, it seems that under English law, a contractual duty to use best endeavors to achieve a defined object is enforceable, while the courts will not enforce and, thus will not imply an obligation to use best endeavors to achieve an indefinite object, e.g. an obligation to use best endeavors to agree a mutually acceptable price.¹⁷⁸⁴ On the other

¹⁷⁷⁸ Ibid.

¹⁷⁷⁹ [1992] 2 A.C. 128

¹⁷⁸⁰ [1992] 2 A.C. 128

¹⁷⁸¹ (1994) 70 P. & C.R. 469

¹⁷⁸² Ibid., at 475

¹⁷⁸³ Ibid., at 476

¹⁷⁸⁴ *London & Regional Investments Limited v TBI plc* [2002] EWCA Civ 355: It was held that an obligation to “use reasonable endeavours to agree the terms of a joint venture regarding Cardiff and Belfast Airports” was no more than an agreement to agree. It was therefore unenforceable. *Multiplex Constructions (UK) Ltd v Cleveland Bridge UK Ltd* [2006] EWHC 1341 (TCC): Mr Justice Jackson held that the obligation that the parties shall use reasonable endeavours to agree to re-programme the completion of the subcontract works and to agree a fixed lump sum and/or reimbursable subcontract sum for the completion of subcontract works was unenforceable.

hand, the Scottish court recently expressed the view that “If the courts are prepared to police an obligation to use reasonable endeavours to obtain a planning permission or an export licence, as Lord Ackner suggested in *Walford v Miles*, or to use all reasonable endeavours to secure a planning agreement with a local authority (*Yewbelle Ltd v London Green Developments Ltd* [2008] 1 P & CR 17 (CA)), the court should be able to police the negotiation of a price so long as the object of the negotiations can be objectively ascertained.”¹⁷⁸⁵

In the US, one of the leading cases with regard to the interpretation of best efforts obligations is *Bloor v. Falstaff Brewing Corp.*¹⁷⁸⁶ Falstaff brewery promised to “use its best efforts to promote and maintain a high volume of sales” of the products of the Ballantine Brewery after having acquired most of the distribution network and related assets of Ballantine. Falstaff also agreed to pay royalties to Ballantine on the sales achieved. Later, due to the losses it incurred as a result of this activity, Falstaff decided to promote its own beer instead of Ballantine’s. Thus, the sales and royalties of Ballantine decreased, and the former owner of Ballantine claimed that Falstaff breached its “best efforts” obligation. The Court of Appeals found Falstaff in breach of its “best efforts” obligation, and held that “Although we agree that even this did not require Falstaff to spend itself into bankruptcy to promote the sales of Ballantine products, it did prevent the application to them of ... philosophy of emphasizing profit uber alles without fair consideration of the effect on Ballantine volume.” With regard to the burden of proof, the Court held that “Plaintiff was not obliged to show just what steps Falstaff could reasonably have taken to maintain a high volume for Ballantine products. It was sufficient to show that Falstaff simply didn’t care about Ballantine’s volume and was content to allow this to plummet so long as that course was best for Falstaff’s overall profit picture, an inference which the judge permissibly drew. The burden then shifted to Falstaff to prove there was nothing significant it could have done to promote Ballantine sales that would not have been financially disastrous.”¹⁷⁸⁷

Judge Brieant at trial had determined the damages by subtracting Ballantine’s actual sales from the sales that would have been made had Falstaff used its best efforts, by accepting the expert witness’ estimate based on the assumption that Ballantine’s sales would have followed the same trend as two other small New York labels, Schaefer and Rheingold, which belonged to two different vertically integrated firms.¹⁷⁸⁸ Although admitting that the award may overcompensate the plaintiff since Falstaff was not necessarily required to do whatever Rheingold and Schaefer did, the Court of Appeals held that this kind of uncertainty is permissible in favor of a plaintiff who has established liability in a case where a person violating his contract should not be permitted entirely to escape liability because the amount of damage which he caused is uncertain.¹⁷⁸⁹

This decision entailed many doctrinal comments. Goldberg criticized this decision on the ground that the court did not interpret “best efforts” clause in the context of a “one-shot sale of assets”. He argued that where the language is inherently ambiguous, the court should not

¹⁷⁸⁵ *R& D Construction Group Ltd v Hallam Land Management Ltd* [2009] CSOH 128

¹⁷⁸⁶ 454 F. Supp. 258 (S.D.N.Y. 1978), *aff’d*, 601 F.2d 609 (2d Cir. 1979) (Friendly, J.).

¹⁷⁸⁷ 601 F.2d 609 (2d Cir. 1979), at 614-615

¹⁷⁸⁸ 454 F. Supp. 258 (S.D.N.Y. 1978), at 280-281

¹⁷⁸⁹ 601 F.2d 609 (2d Cir. 1979) citing the decision of *Wakeman v. Wheeler & Wilson Mfg. Co.*, 101 N.Y. 205, 209, 4 N.E. 264 (1886)

impose an irrational agreement upon the parties, but should use the context in interpreting the contract. The emphasis should not be on what these parties meant, but on what reasonable people in this situation should have meant.¹⁷⁹⁰ He suggested that “best efforts” in this context means that Falstaff agreed that in its pursuit of “profit uber alles” it would not opportunistically divert sales from Ballantine to Falstaff. He observed from the facts of the case that Falstaff did not use the network to divert more sales than the parties should reasonably have expected, since Falstaff did not divert resources to the more profitable brand, but simply terminated a project that did not work.¹⁷⁹¹

Farnsworth argued that, in the cases similar to *Bloor v. Falstaff*, the interests of the two parties in a best efforts obligation conflict when, it is in the interest of the promisor to maximize net profit while it is in the interest of the promisee to maximize gross receipts.¹⁷⁹² Farnsworth observed that the courts sometimes imagine the promisor and the promisee as if united in a single person and ask what efforts a reasonable person in that situation would exert on his or her own behalf, which is likely response if, for example, the standard is applied to an agent. Such an approach was elaborated by Goetz and Scott’s definition of best efforts, which is derived from an “economic conceptualization of the problem faced by two parties who are attempting to set a contractual volume in which they have joint interests.”¹⁷⁹³ They defined the best efforts obligations on the basis of “joint maximization volume,” which “directs the outcome that maximizes the net gains that parties could achieve from their contractual relationship.”¹⁷⁹⁴ They argued that the best effort standard should require the parties to share the risk of loss arising from the conflict, as in the case of the vertically integrated actor, who is both manufacturer and distributor. The vertically integrated actor would maximize his profits by continuing to produce and distribute so long as the sales price exceeds the sum of marginal manufacturing costs and marginal distribution costs. Accordingly, the best efforts obligations between two distinct parties might be defined as this point of joint maximization and would require one party to set that volume which maximizes the sum of his and the profits of the other party. However, they acknowledged that thus defined best efforts obligation inherently implies a serious monitoring problem, since the parties will not be able to discern the joint maximization volume when they cannot monitor each other’s costs.¹⁷⁹⁵

It is observed that US courts have sometimes responded to best efforts obligations by imagining a third person to be in the promisor’s place to ask what efforts a reasonable person in that situation would exert, where similar instances can be found in the contracting practice. For instance, in extractive industries, leasing of mineral rights is sufficiently common practice that standards of best efforts are likely to have developed. It was held that a lessee who is bound to use best efforts under a mineral lease on a royalty basis “must conform to, and be governed by, what is expected of persons in the industry of ordinary prudence under similar circumstances and conditions, having due regard for the interest of both contracting

¹⁷⁹⁰ Goldberg, Victor P., *Great Contracts Cases: In Search of Best Efforts: Reinterpreting Bloor v. Falstaff*, Saint Louis University Law Journal, 44 (Fall 2000), at 1484

¹⁷⁹¹ *Ibid.*, at 1480

¹⁷⁹² Farnsworth, E.A., *On Trying to Keep One’s Promises: The Duty of Best Efforts In Contract Law*, University of Pittsburgh Law Review, 46 (Fall 1984), at 10

¹⁷⁹³ Goetz, Charles J., & Robert E. Scott, *Principles of Relational Contracts*, Virginia Law Review, 67-6 (1981), at 1111

¹⁷⁹⁴ *Ibid.*, at 1114

¹⁷⁹⁵ *Ibid.*, at 1115

parties.”¹⁷⁹⁶ Similarly, in cases involving an architect or lawyer, whose occupation is to make special skills available to those who do not possess those skills, the courts are less likely to imagine that promisor and promisee are united in the same person, and “best efforts” are to be interpreted by reference to the reasonable care and level of competence that one would normally expect from a professional in the field.¹⁷⁹⁷

This approach is also elaborated by Goetz and Scott in their alternative concept in determining best efforts obligations, which is called “diligence insurance”. Under this alternative, best efforts obligation requires the exercise of due diligence or reasonably prudent business conduct.¹⁷⁹⁸ Long argued that diligence insurance should be the preferable standard of performance of best efforts obligations in the US. He noted that industry practices could be used by the courts, where available but, if well-defined commercial norms existed, parties would incorporate them into their contracts by reference, thereby avoiding some of the uncertainty of best efforts.¹⁷⁹⁹ Thus, in his view, the standard of diligence insurance requires only that the promisor maximize his own profits, and his liability arises only when he, through incompetence or spite, fails to serve even his own interests. Long believed that, while joint maximization volume fails to secure the expectations of either party as neither knows what he is entitled to give or receive until an ex post judicial determination that will likely disappoint one if not both parties, diligence insurance minimizes uncertainty for both parties so that the gains resulting from increased certainty can be distributed through contract price adjustments to benefit both parties.¹⁸⁰⁰

In the US, the starting point for the implied terms of best efforts duties is the decision in *Wood v. Lucy, Lady Duff-Gordon* rendered in 1917.¹⁸⁰¹ Lady Lucy Duff-Gordon signed a contract with Wood giving the latter the exclusive right to market garments and other products bearing her endorsement for one year in exchange of half of all revenues thus derived.¹⁸⁰² Wood filed a lawsuit against Lucy claiming that Lucy had begun to design fashions without Wood's knowledge and without sharing profits with him. In response, Lucy claimed that their agreement failed for the lack of consideration since Wood had not made an express promise to do anything. Judge Cardozo, delivering the opinion of the Court of Appeals of New York, found consideration in Wood's implied promise to use “reasonable efforts to bring profits and revenues into existence.”¹⁸⁰³ Judge Cardozo stated that “[Lucy's] sole compensation for the grant of an exclusive agency is to be one-half of all the profits resulting from the plaintiff's efforts. Unless he gave his efforts, she could never get anything. Without an implied promise, the transaction cannot have such business 'efficacy as both

¹⁷⁹⁶ *Nordan-Lawton Oil & Gas Corp. v. Miller*, 272 F. Supp. 125, 135 (W.D. La. 1967), *aff'd*, 403 F.2d 946 (5th Cir. 1968). See also *Shell Petroleum Corp. v. Shore*, 72 F.2d 193, 194 (10th Cir. 1934) (oil and gas lease); *Brewster v. Lanyon Zinc Co.*, 140 F. 801, 814 (8th Cir. 1905) (oil and gas lease)

¹⁷⁹⁷ Farnsworth, E.A., *On Trying to Keep One's Promises: The Duty of Best Efforts In Contract Law*, *University of Pittsburgh Law Review*, 46 (Fall 1984), at 9

¹⁷⁹⁸ Goetz, Charles J., & Robert E. Scott, *Principles of Relational Contracts*, *Virginia Law Review*, 67-6 (1981), at 1117-1118

¹⁷⁹⁹ Long, Lawrence S., *Best Efforts as Diligence Insurance: In Defense of "Profit Uber Alles"*, *Columbia Law Review*, 86-8 (Dec., 1986), at 1733

¹⁸⁰⁰ *Ibid.*, at 1728

¹⁸⁰¹ 222 N.Y. 88, 118 N.E. 214 (1917)

¹⁸⁰² *Ibid.*, at 90

¹⁸⁰³ *Ibid.*, at 92

parties must have intended that at all events it should have" But the contract does not stop there. The plaintiff goes on to promise that he will account monthly for all moneys received by him, and that he will take out all such patents and copyrights and trademarks as may in his judgment be necessary to protect the rights and articles affected by the agreement... His promise to pay the defendant one-half of the profits and revenues resulting from the exclusive agency and to render accounts monthly was a promise to use reasonable efforts to bring profits and revenues into existence."¹⁸⁰⁴ Later decisions confirmed this method of implication of terms in fact, by using, without distinction, the expressions "best effort" and "reasonable efforts", which were considered to be interchangeable.¹⁸⁰⁵ Thus, this case has evolved into a term implied in law whereby the payment on a royalty or similar basis in return for an exclusive right gives rise to the implied duty of best efforts for the holder of such a right.¹⁸⁰⁶

In *Contemporary Mission, Inc. v. Famous Music Corp.*, the United States Court of Appeals for the Second Circuit dealt with the issue of burden of proof in the case of breach of an implied obligation of best efforts. In the case, a group of Catholic priests sold for a royalty the exclusive rights to manufacture and distribute records of their opera to Famous Music. Among its other obligations, Famous Music was to spend not less than \$50,000 on promotion unless "in the sole option of Famous Music Corporation, such promotion shall cease to be effective and profitable."¹⁸⁰⁷ Famous Records invoked this clause to justify ending all promotional activities. The court held that, despite the terms of the provision, the decision was not at Famous Music's complete discretion since it had assumed an implied obligation to use its "best efforts" to ensure the promotion of the opera, under the Wood doctrine, and mere "technical compliance" with the terms of the agreement did not discharge this obligation.¹⁸⁰⁸ As in the case of *Falstaff*, the court considered that the burden of proof was on Famous Music, the promisor of the implied "reasonable effort" obligation, to prove that he had not failed in this obligation as it considered that the burden of uncertainty as to the amount of damage was upon the wrongdoer.

In *Zilg v. Prentice-Hall*, the United States Court of Appeals for the Second Circuit reached a different conclusion with regard to the burden of proof as a result of its endorsement of "diligence insurance", in the form of a "good faith business judgment", in determining the scope of implied best efforts obligation.¹⁸⁰⁹ Zilg wrote a book, and entered into a contract with Prentice-Hall, which obtained the exclusive right "to determine the method and means of advertising, publicizing, and selling the work, . . . and all other publishing details, including the number of copies to be printed."¹⁸¹⁰ The contract specifically gave the publisher the power in its discretion to decide on the number of volumes printed and the level of promotional

¹⁸⁰⁴ *Ibid.*, at 91-92

¹⁸⁰⁵ Long, Lawrence S., *Best Efforts as Diligence Insurance: In Defense of "Profit Uber Alles"*, *Columbia Law Review*, 86-8 (Dec., 1986), at 1728 fn 6

¹⁸⁰⁶ Section 2-306(2) of the UCC: A lawful agreement by either the seller or the buyer for exclusive dealing in the kind of goods concerned imposes unless otherwise agreed an obligation by the seller to use best efforts to supply the goods and by the buyer to use best efforts to promote their sale. Farnsworth, E.A., *On Trying to Keep One's Promises: The Duty of Best Efforts In Contract Law*, *University of Pittsburgh Law Review*, 46 (Fall 1984), at 10

¹⁸⁰⁷ 557 F.2d 918 (2d Cir. 1977), at 920-923 n.8 (quoting contract).

¹⁸⁰⁸ *Ibid.*, at 923

¹⁸⁰⁹ 717 F.2d 671 (2d Cir. 1983), cert. denied, 466 U.S. 938 (1984) (Zilg lost a Supreme Court appeal)

¹⁸¹⁰ 717 F.2d, at 674

expenditures. Following the extremely negative reaction of a book club, Prentice-Hall decided to decrease the size of the first printing and to cut the advertising budget. Zilg sued Prentice-Hall for breach of contract claiming that the publisher had not tried hard enough to promote his book.¹⁸¹¹ The Federal District Court found that the publishing contract required the publisher to “exercise its discretion in good faith in planning its promotion of the Book, and in revising its plans.” This obligation required that Prentice-Hall use “its best efforts ... to promote the Book fully and fairly.” The district court held that Prentice-Hall breached this obligation because it had no “sound” or “valid” business reason for reducing the first printing or the advertising budget.¹⁸¹²

The United States Court of Appeals for the Second Circuit disagreed with this conclusion. The court noted that “Zilg neither bargained for nor acquired an explicit 'best efforts' or 'promote fully' promise, much less an agreement to make certain specific promotional efforts.”¹⁸¹³ The court contrasted this aspect with that in issue in *Contemporary Mission, Inc. v. Famous Music Corp.*, which contained specific promotional obligations with regard to a musical group. The court held that “the promise to publish must be given some content and that it implies a good faith effort to promote the book including a first printing and advertising budget adequate to give the book a reasonable chance of achieving market success in light of the subject matter and likely audience.”¹⁸¹⁴ In order not to hamper the publisher's ability to rely upon its own experience and judgment in marketing books, the court concluded that “once the obligation to undertake reasonable initial promotional activities has been fulfilled, the contractual language dictates that a business decision by the publisher to limit the size of a printing or advertising budget is not subject to a second guessing by a trier of fact as to whether it is sound or valid”. Thus, in view of the court, “Once the initial obligation is fulfilled, all that is required is a good faith business judgment.”¹⁸¹⁵

The Court of Appeals determined that the burden of proof is not on the promisor of the “reasonable efforts” obligation, but on the promise. The court stated that “a breach of contract might be proven by Zilg in two ways. First, he might demonstrate that the initial printing and promotional efforts were so inadequate as not to give the book a reasonable chance to catch on with the reading public. Second, he might show that even greater printing and promotional efforts were not undertaken for reasons other than a good faith business judgment”. Zilg failed to produce such evidence. The court then concluded that Prentice-Hall had tried hard enough to perform its initial obligation on the basis of the testimony of Prentice-Hall's expert witness, who testified that the promotional efforts were “perfectly adequate” even though they were “routine” and Prentice-Hall “did not follow through as they might.”¹⁸¹⁶ As this initial obligation had been met, the court held that all the publisher had to do was to exercise its discretion in good faith and Zilg failed to produce any evidence to show “that the motivation underlying [the publisher's later] decisions was not a good faith business judgment.”¹⁸¹⁷

¹⁸¹¹ Ibid., at 673

¹⁸¹² Ibid., at 676

¹⁸¹³ Ibid., at 679

¹⁸¹⁴ Ibid., at 680

¹⁸¹⁵ Ibid.

¹⁸¹⁶ Ibid., at 681

¹⁸¹⁷ Ibid.

It appears that the US courts' approach to implicit or explicit "best efforts" obligations has a great relevance to the burden of proof. Traditionally, under the common law, the party alleging the existence of the breach of contract should prove that a breach has occurred, and he is not under the burden to prove that the other party has been at fault in his breach.¹⁸¹⁸ The traditional strict liability regime prevents the party in breach from avoiding liability by proving that he was not at fault in the sense that he took all reasonable steps or performed his best or reasonable efforts to ensure the proper performance of his obligations.¹⁸¹⁹ The duty of best efforts is one of the many exceptions to this liability regime. The US case law suggests that express or implied "best efforts" obligations alters the scheme of burden of proof in establishing the liability of the promisor in two ways depending on the approach adopted by the court with regard to its response to such obligations.

First, if the court, as in *Falstaff* case, determines the scope of the best effort obligation on the basis of the joint maximization volume, i.e. the efforts of a reasonable person where the promisor and the promisee are united in a single person, then the promisee is only required to prove the existence of the non-performance, which seems conforming to the scheme of burden of proof under strict liability regime. However, there is uncertainty relating to the extent of damages arising from a best effort obligation thus determined due to the monitoring problems in determining the joint maximization volume. As this burden of uncertainty is imposed on the wrongdoer, i.e. the promisor, and not on the promisee who has already established liability, the promisor should prove that he has done its best under the circumstances in order to escape liability. Thus, the duty of best efforts, when determined on the basis of joint maximization volume, functions as a rebuttable presumption of fault, which can be found in the liability regime of civil legal systems. On the other hand, if the court understands the best efforts obligations as "diligence insurance" according to which, best efforts obligation requires the exercise of due diligence or reasonably prudent business conduct, as in the *Zilg* case, the promisee is required to prove that the promisor did not act with the required diligence in order to establish liability.

It is argued that the duty of best efforts is the common law counterpart of the concept of "undertaking to appropriate means" ("obligation de moyens") under French law.¹⁸²⁰ French law distinguishes two kinds of contractual obligations between "undertakings to appropriate means" ("obligations de moyens") and "undertakings to achieve a promised result" ("obligations de résultat"). This distinction has become a basic tool of analysis for lawyers not only in France but also in many civil law countries, including Belgium, the Netherlands, Italy and Quebec.¹⁸²¹ It is based on the observation that a contractual obligation can be assumed with different degrees of intensity. Sometimes, the promisor's obligation is to achieve a certain result. In other cases, the promisor's obligation is merely to use appropriate means to achieve a promised result, without guaranteeing the result; in other words, the promisor is

¹⁸¹⁸ Section 235 of the Restatement (Second) of Contracts, comment b: "When performance is due, however, anything short of full performance is a breach, even if the party who does not fully perform was not at fault and even if the defect in his performance was not substantial. Non-performance of a duty when performance is due is a breach whether the duty is imposed by a promise stated in the agreement or by a term supplied by the court (§ 204), as in the case of the duty of good faith and fair dealing (§ 205). Non-performance includes defective performance as well as an absence of performance."

¹⁸¹⁹ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 390

¹⁸²⁰ Farnsworth, E.A., *On Trying to Keep One's Promises: The Duty of Best Efforts In Contract Law*, *University of Pittsburgh Law Review*, 46 (Fall 1984), at 4

¹⁸²¹ Fontaine, Marcel, *Content and Performance*, *American Journal of Comparative Law*, 40 (1992), at 648

merely obliged to exert a certain degree of efforts to perform the obligation, but with no firm undertaking as to the achievement of any certain result.¹⁸²²

This distinction affects the conditions of contractual liability, and particularly the burden of proof. Under French law, any non-performance of a contractual obligation, when arising from a promisor, is a fault in the absence of an external cause, such as force majeure or fault of the victim, the proof of which is incumbent on the promisor.¹⁸²³ If there is an undertaking to achieve a promised result, the promisee is only required to prove that the promised result has not been achieved in order to establish liability, in which the fault of the promisor is presumed, thereby leaving the promisor with the burden of trying to establish an exculpatory cause, such as force majeure or the interference of the other party or a third party making it impossible for it to fulfill its obligations. In the case of an undertaking to appropriate means, the promisee has to prove that the promisor did not act with the required diligence in the sense that the promisor behaved in a manner which did not correspond to what the promisee is entitled to expect.¹⁸²⁴ As the basis for the development of the concept of obligations to appropriate means is the text of Article 1137 of the French Civil Code, regarding the safe keeping of objects, which referred to the “good family man”, the general trend is the adoption of an objective standard of diligence in evaluating the behavior of the debtor, but the specific circumstances of the debtor and the purpose of the contract is also taken into account.¹⁸²⁵ Thus, fault in the sense of “lack of diligence” needs to be proved to establish contractual liability for non-performance only where the obligation in question is classified as an undertaking to appropriate means, and there is no such need as regards the undertakings to achieve a promised result.¹⁸²⁶

Although constantly used by the lawyers in the French tradition, the distinction is not always clear, in practice. The characterization of a given obligation as an undertaking to appropriate means or to achieve a certain result will depend on various factors. The wording of the terms of agreement can be decisive. When the wording is uncertain, the court will characterize the obligation by taking into account the degree of risk that threatens the success of the performance promised; if it is a performance that normally ends with a positive result, the court will characterize the obligations as an undertaking to achieve a certain result, but if performance would normally involve difficulties and success cannot be guaranteed, the obligation will be characterized as an undertaking to appropriate means.¹⁸²⁷

Under French law, one of the fields that the distinction has become unclear is the interpretation of the letters of comfort. A letter of comfort is intended to reassure a party, contracting with a subsidiary, of the support that the parent company is prepared to give it

¹⁸²² Ibid., at 649

¹⁸²³ See Article 1147 of the French Civil Code; Chappuis, Christine, Provisions for Best Efforts, Reasonable Care, Due Diligence and Standard Practice in International Contracts, *International Business Law Journal*, (2002), at 289

¹⁸²⁴ Ibid., at 290

¹⁸²⁵ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 220

¹⁸²⁶ Bell, John, Sophie Boyron & Simon Whittaker, *Principles of French law*, Oxford University Press, 2nd ed., 2008, at 343

¹⁸²⁷ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 219

subsidiary in the event it encounters financial difficulties. As the issuer of a comfort letter does not intend to give a guarantee to make payment itself once a particular condition is fulfilled, such as the inability of the subsidiary to pay its debts, the letter usually contains vague references, such as “best efforts”, in defining the support obligation of the parent company.¹⁸²⁸ Sometimes, the parent companies undertake “to do all that is possible” or “to do everything in its power” with regard to its obligations under the letter of comfort. A variety of interpretations appeared in the French case law, where the obligation “to do all that is possible” is interpreted as an undertaking to achieve a promised result and the obligation “to do its best efforts” is characterized as an undertaking to appropriate means. The courts also examined the circumstances surrounding the signature of the agreement between the subsidiary and the third party. For example, if the parent company directly participated in the negotiation of the main agreement at the decision-making level, the third party would be entitled to believe that the parent company assumed a factual or legal ability to cause the debtor to fulfill its obligations as an undertaking to achieve a specified result.¹⁸²⁹

Although, fault-based regime of liability is generally adopted in civil law systems, the existence of fault is usually not relevant to the determination of liability since there is a default presumption of fault of the debtor, which enables the creditor to establish liability by proving the breach, damage and cause. For instance, the burden of proof with regard to fault is on the debtor under German law. While the German Civil Code of 1900 provided this burden of proof only in instances of impossibility and default (Sections 282 and 285), after the fundamental reform in 2002, the presumption of fault has become a general rule. This presumption follows from the negative wording of the central norm for damages for breach of contract in Section 280 (1) of the German Civil Code, the second part of which provides that damages are owed unless the debtor proves absence of fault, i.e. he has acted neither deliberately nor negligently.¹⁸³⁰

¹⁸²⁸ Elland-Goldsmith, Michael, Comfort letters in English law and practice, *International Business Law Journal*, (1994), at 527-541; An example reads as the following, “If the Borrower is unable, for any reason, to effect any payment under such agreement when due, we shall use our best efforts in order to have funds available to the Borrower... by any appropriate means in amount sufficient to make such payment.” Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 198-199

¹⁸²⁹ Terray, Jacques, Letters of Comfort in French Law, *International Financial Law Review*, 1 (1982), at 36; In the decision rendered by the Tribunal de Commerce de Paris on October 27, 1981, the author of the letter of comfort was ordered to pay the full amount owed by the debtor, since the judges deduced from the circumstances and the drafting of the letter that the author’s commitment was that the bank would be fully reimbursed rather than a mere best efforts obligation, since, in the letter of comfort, the author undertook to take all necessary measures to ensure that the debtor would be in a position to reimburse its debt. However, such an interpretation raised questions as to whether the validity of a letter of comfort is subject to the same conditions as a guarantee. In French law, a guarantee may not be validly issued by the representatives of a stock company unless it has previously been authorized by the board of directors, under the Law of July 24, 1966. On this issue, the Cour de Cassation defined the undertaking to achieve a specific result, which requires such an authorization, as the commitment by a parent company to pay en lieu et place of the subsidiary, or to substitute for it in the performance of its obligation towards the creditor, so that other types of commitments of the parent company are to be interpreted as undertakings to appropriate means. Chappuis, Christine, Provisions for Best Efforts, Reasonable Care, Due Diligence and Standard Practice in International Contracts, *International Business Law Journal*, (2002), at 287

¹⁸³⁰ Riesenhuber, Karl, Damages for Non-Performance and the Fault Principle, *European Review of Contract Law*, 4 (2008), at 131-132 Also see Article 97 (1) of the Swiss Code of Obligations: “If the performance of an obligation can not at all or not duly be effected, the obligor shall compensate for the damage arising therefrom, unless he proves that no fault at all is attributable to him.”

Moreover, Section 276 (1) of the German Civil Code provides that a stricter type of liability may be inferred from the content of an obligation: for instance, from giving of a guarantee or the assumption of a procurement risk. Although, the reform of Section 276 was intended primarily to clarify the law, it is argued that the way in which the new rule is drafted leaves much leeway for a flexible adjustment of the standard of liability.¹⁸³¹ Section 276 (2) provides contractual liability for negligence. The negligence under this rule is defined as an objective standard in the sense that a person acts negligently if he fails to observe the relevant accepted standards of care, according to which the courts have applied an objective analysis to determine fault, considering the typical knowledge and ability of a person of the profession in question rather than the individual knowledge and ability.¹⁸³² It is argued that the presumption of fault and objective standard of care are the factors that bring German law rather close to a strict liability regime even where it formally provides exclusively for fault liability.¹⁸³³

Under German law, the distinction between undertakings to appropriate means and undertakings to achieve a promised result can be found with regard to the certain types of contracts, but it is not a central issue of the debate on contractual liability. The required performance of an undertaking can consist either of a result (“Erfolg”), such as in a works contract (“Werkvertrag”), or of an activity or effort (“Tätigkeit”), such as contracts for services (“Dienstvertrag”).¹⁸³⁴ Thus, the type and nature of contract is directly relevant to the determination of whether the debtor is obliged to produce a result or to exert his best efforts. With regard to works contracts, Section 633 of the German Civil Code provides that the debtor must procure the work for the creditor free of material defects and legal defects. Section 634 provides that if the work is defective, the creditor may resort to certain remedies that apply, regardless of fault, such as the right to demand that repairs be carried out or to bring an action for reduction of the price. Thus, German law imposes a guarantee obligation on the debtor in the works contract to perform a definite type of work but, to the extent that the creditor wishes to obtain damages and interest, the fault of debtor becomes relevant through the general presumption of fault. On the other hand, in the cases of contracts for services, the debtor mainly assumes an obligation of reasonable care and diligence.¹⁸³⁵ It is argued that the “best efforts” clauses (“nach besten Kräften”) in contracts can be construed under German law as the parties’ intention to replace the objective standard of default liability regime with an assessment of the requisite degree of care to be made in a subjective manner, which may lead to an increase or to a decrease in liability or even to an exemption from liability, on the basis of the debtor's competence.¹⁸³⁶

¹⁸³¹ Zimmermann, Reinhard, *Breach of Contract and Remedies Under the New German Law of Obligations*, Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari 48, Rome, 2002, at 18: German Civil Code of 1900 in Section 276 (1) merely stated that the debtor is responsible for fault either in the form of intention or negligence, unless something else is specifically provided.

¹⁸³² Riesenhuber, Karl, *Damages for Non-Performance and the Fault Principle*, *European Review of Contract Law*, 4 (2008), at 130

¹⁸³³ Grundmann, Stefan, *the Fault Principle as the Chameleon of Contract Law: a Market Function Approach*, *Michigan Law Review*, 107 (June 2009), at 1587

¹⁸³⁴ Witz, Claude, & Thomas M. Bopp, *Bests Efforts, Reasonable Care: Considérations de droit allemande*, *International Business Law Journal*, (1988), at 1035

¹⁸³⁵ Riesenhuber, Karl, *Damages for Non-Performance and the Fault Principle*, *European Review of Contract Law*, 4 (2008), at 150

¹⁸³⁶ Witz, Claude, & Thomas M. Bopp, *Bests Efforts, Reasonable Care: Considérations de droit allemande*, *International Business Law Journal*, (1988), at 1037

b. International Instruments

The CISG provides for strict liability for non-performance under Article 74, independent of any fault of the party in breach, while there are exemptions from liability provided in Article 79 for supervening impediments, and in Article 80 for non-performance caused by the aggrieved party.¹⁸³⁷ Because of the importance of the CISG, the strict liability regime has remained on the international agenda, and it has been adopted by the international restatements of contract law.¹⁸³⁸ Although, the distinction between undertakings to appropriate means and undertakings to achieve a promised result is not explicitly provided under the CISG, there are several provisions, which refer to concepts such as “reasonable steps” or “reasonable measures” in defining the obligations of the parties, instead of defining absolute undertakings.¹⁸³⁹

Following the example of the CISG, both UNIDROIT Principles and the PECL adopt the strict liability regime.¹⁸⁴⁰ Both sets of principles take into account the variations, by implicit or explicit agreement, of the parties’ expectations with regard to the intensity or scope of obligations. Article 5.1.4 of the UNIDROIT provides that “To the extent that an obligation of a party involves a duty to achieve a specific result, that party is bound to achieve that result”, and “To the extent that an obligation of a party involves a duty of best efforts in the performance of an activity, that party is bound to make such efforts as would be made by a reasonable person of the same kind in the same circumstances.” In the Official Comments, it is explained that Article 5.1.4 provides the decision maker with criteria by which correct performance can be evaluated. Accordingly, the nature of the obligation determines the “degree of diligence required of a party in the performance of the obligation”.¹⁸⁴¹ The Official Comments state that “In the case of an obligation to achieve a specific result, a party is bound simply to achieve the promised result, failure to achieve which amounts in itself to non-performance, subject to the application of the force majeure provision (see Article 7.1.7). On the other hand, the assessment of non-performance of an obligation of best efforts calls for a less severe judgment, based on a comparison with the efforts a reasonable person of the same kind would have made in similar circumstances. This distinction signifies that more will be expected from a highly specialised firm selected for its expertise than from a less sophisticated partner.”¹⁸⁴² This criterion is deemed as a contemporary rendition of the good family man’s behavior under French law.¹⁸⁴³ Thus, in determining the scope of “best efforts”

¹⁸³⁷ Knapp, Victor, Article 74, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 540

¹⁸³⁸ Grundmann, Stefan, *the Fault Principle as the Chameleon of Contract Law: a Market Function Approach*, *Michigan Law Review*, 107 (June 2009), at 1584

¹⁸³⁹ See Articles 85, 86 and 88 of the CISG

¹⁸⁴⁰ See Article 7.4.1 of the UNIDROIT Principles and Article 8:101 of the PECL

¹⁸⁴¹ During the drafting process, it was suggested to use the term “duty of diligence”, rather than “duty of best efforts” UNIDROIT 1986 – P.C. – Misc. 8, Rome, February 1986, para 5; UNIDROIT 1990 – P.C. – Misc. 14, Rome, July 1990, at 9; UNIDROIT 1991 – Study L – Doc. 40 Rev. 8, Rome, June 1991 draft Article 5.1.3; Other early drafts employed the term “duty of care”: UNIDROIT 1985 – Study L – Doc. 34, Rome, October 1985, draft Article 2; UNIDROIT 1987 – Study L – Doc. 39, Rome, April 1987, draft Article 2; see also UNIDROIT 1987 – P.C. – Misc. 11, Rome, July 1987, paras 3, 5.

¹⁸⁴² Official Comment 2 to Article 5.1.4 of the UNIDROIT Principles; In the illustration 2, the relevant circumstances in the context of a distribution contract is listed as, nature of the product, characteristics of the market, importance and experience of the firm, presence of competitors, etc.

¹⁸⁴³ Fontaine, Marcel, *Content and Performance*, *American Journal of Comparative Law*, 40 (1992), at 650

obligations, the Article 5.1.4 refers to the general interpretative criteria of reasonableness test, which combines objective and subjective elements. It is also pointed out in the Official Comments that obligations of both types may coexist in the same contract, such as the case where a firm that repairs a defective machine may be considered to be under a duty of best efforts concerning the quality of the repair work in general, and under a duty to achieve a specific result as regards the replacement of certain spare parts.¹⁸⁴⁴

As the UNIDROIT Principles adopt the strict liability regime, it is stated in the Official Comments to Article 7.4.1 regarding right to damages that it is enough for the aggrieved party simply to prove the non-performance, i.e. that it has not received what it was promised, without proving in addition that the non-performance was due to the fault of the non-performing party, but the degree of difficulty in proving the non-performance will depend upon the content of the obligation and in particular on whether the obligation is one of best efforts or one to achieve a specific result.¹⁸⁴⁵ It is argued that the distinction between undertakings to appropriate means and undertakings to achieve a specific result does not perform a useful function and it is superfluous under the UNIDROIT Principles due to its strict liability regime.¹⁸⁴⁶ This argument is based on the observation that this distinction is modeled on the basis of the French law of contract, which takes fault as an essential element of breach, while under the UNIDROIT Principles all liability is strict.¹⁸⁴⁷ Therefore, it is argued that the distinction has lost its juridical significance.¹⁸⁴⁸ Similarly, at various stages of the drafting process, the drafters, who prepared Chapter 5 of the Principles, expressed their “doubts about the usefulness” of the draft provisions from which Article 5.1.4 emerged.¹⁸⁴⁹ However, the distinction was maintained because the members of the Working Group considered it to be “both interesting and useful”, and because they hoped that it would draw the attention of the parties to the necessity of specifying in the contract which kind of engagement is envisaged.¹⁸⁵⁰ It was also deemed useful for judges and arbitrators who, in the absence of clear language in the contract, are called upon to define the exact nature of the parties' duties.¹⁸⁵¹

The decision whether a particular duty is an undertaking to appropriate means or an undertaking to achieve a specific result depends on the application of the criteria provided in Article 5.1.5. Article 5.1.5 provides a non-exhaustive list of factors to be taken into account in determining the extent to which an obligation of a party involves a duty of best efforts or a

¹⁸⁴⁴ Official Comment No 1 to Article 5.1.4 of the UNIDROIT Principles

¹⁸⁴⁵ Official Comment No 1 to Article 7.4.1 of the UNIDROIT Principles

¹⁸⁴⁶ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 550

¹⁸⁴⁷ Indeed Article 5.1.4 of the UNIDROIT Principles follows the distinction in French law between “obligations de résultat”, and “obligations de moyens” as these terms are used in the French language version Article 5.1.4, and the provision is indeed modeled on the French distinction. UNIDROIT 1987 – Study L – Doc. 39, Rome, April 1987, at 7, UNIDROIT 1987 – P.C. – Misc. 11, Rome, July 1987, para 3, UNIDROIT 1989 – Study L – Doc. 44, Rome, June 1989, at 3

¹⁸⁴⁸ Perillo, Joseph M., *UNIDROIT Principles of International Commercial Contracts The Black Letter Text and a Review*, *Fordham Law Review*, 63 (1994), at 296

¹⁸⁴⁹ UNIDROIT 1987 – Study L – Doc. 39, Rome, April 1987, at 8; UNIDROIT 1989 – Study L – Doc. 44, Rome, June 1989, at 6

¹⁸⁵⁰ UNIDROIT 1987 – P.C. – Misc. 11, Rome, July 1987, paras. 3 and 5

¹⁸⁵¹ Fontaine, Marcel, *Content and Performance*, *American Journal of Comparative Law*, 40 (1992), at 650

duty to achieve a specific result. The list includes factors such as (a) the way in which the obligation is expressed in the contract, (b) the contractual price and other terms of the contract, e.g. an unusually high price, penalty clause or hardship clause may indicate a duty to achieve a specific result in cases where a mere duty of best efforts would normally be assumed, (c) the degree of risk normally involved in achieving the expected result, e.g. when the performance of an obligation normally involves a high degree of risk, it is generally to be expected that result is not guaranteed, and (d) the ability of the other party to influence the performance of the obligation, e.g. if a party has a strong ability to influence the performance of the other party the latter does not normally intend to be under a duty to achieve a specific result.¹⁸⁵² As the determination of the scope of an obligation according to the distinction between a duty to achieve a specific result and a duty of best efforts is a form of the interpretation of the contract, Article 5.1.5 supplements the rules on contractual interpretation in Chapter 4 of the UNIDROIT Principles and the list of factors stated in Article 5.1.5 can be considered as “circumstances” within the meaning of Article 4.3.¹⁸⁵³

Although the PECL do not contain provisions similar to Articles 5.1.4 and 5.1.5 of the UNIDROIT Principles, some scholars interpret the PECL to mirror this approach as the drafters have assumed that the parties are free to contract accordingly.¹⁸⁵⁴ The PECL refer to the distinction between obligations of best efforts and obligations to achieve a specific result, in the Official Comments. With regard to interpretation of contracts, the Official Comments to Article 5:101 draw attention to the possible necessity of deciding whether the debtor's obligation was one to produce a particular result (*obligation de résultat*) or only one to use reasonable care and skill (*obligation de moyens*) in determining the whether there has been a non-performance.¹⁸⁵⁵ Similarly, the Official Comments to Article 6:102 endorse the distinction with regard to implied terms.¹⁸⁵⁶ Moreover, the PECL mentions the distinction in the context of damages for non-performance. The Official Comments to Article 9:501 state that “Where a party’s obligation is to produce a given result, its failure to do so entitles the aggrieved party to damages whether or not there has been fault by the non-performing party, except where performance is excused (see Article 8:108 and Comment). Where a party’s obligation is not to produce a result but merely to use reasonable care and skill it is liable only if it has failed to fulfill its obligation, that is to say if it has not exercised the care and skill it has promised. In the absence of a clause specifying the required degree of care and skill, this is equivalent to the commission of a fault.”¹⁸⁵⁷

¹⁸⁵² Official Comments to Article 5.1.5 of the UNIDROIT Principles

¹⁸⁵³ Although during the drafting process some members argued that there was no need for Art 5.1.5 because it might duplicate the general rules on interpretation, the majority of the Working Group insisted on retaining the article because of the difficulties associated with distinguishing the two types of obligations. UNIDROIT 1987 – P.C. – Misc. 11, Rome, July 1987, para 6

¹⁸⁵⁴ Lando, Ole, Non-Performance (Breach) of Contracts, in in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 509

¹⁸⁵⁵ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 287

¹⁸⁵⁶ *Ibid.*, at 303-304

¹⁸⁵⁷ *Ibid.*, at 434

c. Contracting Practices

In international contracting practice, the parties frequently include in their contracts such clauses that refer to a vague standard in determining the conditions for fulfillment of a contractual obligation rather than directly providing specific conditions for success. These clauses refer to the standard of “best efforts” or one of its variants, such as “reasonable care”, “due diligence” and “standard practices”. When there is a relatively complicated obligation, when the result of the performance of an obligation is not within the promisor’s control, or when the scope of obligation is a result of the negotiating skills and bargaining power of the parties, the party prepared to undertake that obligation does not tend to promise a perfect result; rather he promises to perform a degree of effort, which is vaguely described in the relevant contractual clause, aiming at reaching that result. These clauses, referring to a great variety of standards, appear mainly in certain types of contracts, which have the characteristics of the transactions governed through legal uncertainty.¹⁸⁵⁸ The incorporation of such uncertain standards in the formulation of contractual obligations gives rise to the residual questions.

In the distribution agreements, the distributor often undertakes to promote sales of the products concerned and this obligation is usually defined by a reference to the standard of best efforts, best endeavors, or reasonable efforts.¹⁸⁵⁹ An example provides that “The distributor agrees to use its best efforts to sell, promote, market and support the Products and to develop and maintain the reputation and goodwill of ... and the Products in the Territory with Distributors’ customers.”¹⁸⁶⁰ The ICC Model Commercial Agency Contract combines the best effort undertaking with the requirement of diligence in the same clause.¹⁸⁶¹ Article 3.1 provides that “The Agent agrees to use his best endeavors to promote the sale of the Products in the territory in accordance with the Principal’s reasonable instructions and shall protect the Principal’s interests with the diligence of a responsible businessman.” The Model Contract refers solely to the standard of diligence in the context of the agent’s obligation to inform his principal, as an instance of cooperation between the parties. Article 9.1 provides that “The Agent shall exercise due diligence to keep the principal informed about his activities, market conditions and the state of competition within the Territory...” Article 7.2 of the Model Contract is explicit on the point that the best effort undertaking does not guarantee the result by providing that “The parties shall make their best efforts to attain the [sales] targets agreed upon, but the non-attainment shall not be considered as a breach of the contract by a party, unless that party is clearly at fault.”

¹⁸⁵⁸ These contractual types are distribution agreements, construction agreements, agreements for manufacturing of materials and parts for motor vehicles, research agreements, technical assistance agreements, trademark and patent license agreements, satellite launch agreements, letters of comfort, documentary credits, counter-trade agreements and share purchase agreements. See for examples; Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 188-201

¹⁸⁵⁹ Directive 86/653/EEC considers the agent’s obligation of proper efforts to promote the sales of the product as a specific instance of agent’s general obligation look after his principal’s interests and act dutifully and in good faith. Council Directive 86/653/EEC of 18 December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents, Article 3.2 (a)

¹⁸⁶⁰ Cited by Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 188

¹⁸⁶¹ ICC Model Commercial Agency Contract, 2nd ed., ICC publication, 644, Paris, 2002

In construction contracts, it is often required that the work to be performed by the contractor with a given degree of care, which is expressed in a reference to “reasonable diligence” or “professional standards”.¹⁸⁶² There are also other clauses under the FIDIC Conditions, which contain references to “reasonable efforts”¹⁸⁶³, “best endeavors”¹⁸⁶⁴, “best efforts”¹⁸⁶⁵ and “all reasonable endeavors”¹⁸⁶⁶. The FIDIC Conditions 1987 edition provided in Sub-Clause 8.1 that “The Contractor shall, with due care and diligence, design (to the extent provided by the Contract), execute and complete the Works and remedy any defects therein in accordance with the provisions of the Contract...”¹⁸⁶⁷ The corresponding provisions of the FIDIC Conditions 1999 edition have eliminated this reference to the standard of “due care and diligence” in the descriptions of the Contractor’s obligations.¹⁸⁶⁸ This change serves to tighten the responsibilities of the Contractor. Thus, it is argued that the sub-clause must be read as an absolute obligation.¹⁸⁶⁹ It is further provided in Sub-Clause 4.1 (c) of the FIDIC Conditions 1999 edition that, if the Contract specifies that the Contractor shall design any part of the Permanent Works, the Contractor shall be responsible for this part and it shall, when the Works are completed, be fit for such purposes for which the part is intended as are specified in the Contract. The introduction of this fitness for purpose obligation is a guarantee obligation and arises from the consideration that, in English law, which has influenced the drafting of the FIDIC Conditions, the fitness for purpose duty is stricter than the liability for reasonable competence to exercise due care, skill and diligence.¹⁸⁷⁰ Under the ICC Model

¹⁸⁶² For example, a contract provides that “The contractor shall, commencing within days of the Effective Date of the Contract, proceed with utmost diligence and care in carrying out all of the Services specified as his obligations in the Contracts” and another one provides that “The Consulting Engineer shall exercise all reasonable skill, care and diligence in the performance of the Services under the Agreement and shall carry out all his responsibilities in accordance with recognized professional standards.” Cited by Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 191

¹⁸⁶³ Sub-Clause 4.7: “The Employer shall be responsible for any errors in these specified or notified items of reference, but the Contractor shall use reasonable efforts to verify their accuracy before they are used.” Sub-Clause 4.8: “The Contractor shall:... (c) use reasonable efforts to keep the Site and Works clear of unnecessary obstruction so as to avoid danger to these persons”.

¹⁸⁶⁴ Sub-Clause 6.12: “The Employer will, if requested by the Contractor, use his best endeavours in a timely and expeditious manner to assist the Contractor in obtaining any local, state, national, or government permission required for bringing in the Contractor’s personnel.”

¹⁸⁶⁵ Sub-Clause 15.2: “[In the event of termination by the Employer], the Contractor shall use his best efforts to comply immediately with any reasonable instructions included in the[termination] notice (i) for the assignment of any subcontract, and (ii) for the protection of life or property or for the safety of the Works.”

¹⁸⁶⁶ Sub-Clause 19.3: “Each Party shall at all times use all reasonable endeavours to minimise any delay in the performance of the Contract as a result of Force Majeure.”

¹⁸⁶⁷ Part I, General Conditions, Article 8.1 of the FIDIC Conditions of Contract for Works of Civil Engineering Constructions, 1987 ed.

¹⁸⁶⁸ Article 4.1 of the FIDIC Conditions of Contract for Construction, 1st ed., 1999, the FIDIC Conditions of Contract for Plant and Design-Build, 1st ed., 1999, and the FIDIC Conditions of Contract for EPC Turnkey Projects, 1st ed., 1999

¹⁸⁶⁹ Glover, Jeremy, Simon Hughes, & Christopher Thomas, *Understanding the New FIDIC Red Book: A Clause by Clause Commentary*, Sweet & Maxwell, 2006, at 73

¹⁸⁷⁰ In *Greaves v Baynham Meikle* (1975) 1 W.L.R. 1095: Lord Denning stated that: “Now, as between the building owners and the Contractors, it is plain that the owners made known to the Contractors the purpose for which the building was required, so as to show that they relied on the Contractors skill and judgment. It was therefore, the duty of the Contractors to see that the finished work was reasonably fit for the purpose for which they knew it was required. It was not merely an obligation to use reasonable care, the Contractors were obliged to ensure that the finished work was reasonably fit for the purpose.” In *IBA v EMI and BICC*, (1980) 14

Contract for the Turnkey Supply of an Industrial Plant, Articles 4.5 and 4.6 provide that the supplier guarantees that the plant, once erected and started up, will have the specified performance characteristics but, as to the design of the plant, the supplier only guarantees that the plant has been designed with due care and that it includes everything which is patently necessary for the plant to provide the operating characteristics as defined in the contract.

In share purchase agreements, the “best efforts” clauses generally appear in relation to the parties’ duty of cooperation. The ICC Model Mergers & Acquisitions Contract, Share Purchase Agreement, refers to the standard of “best efforts” or its variants in regulating the duty to mitigate losses arising from a number of events. According to Article 10 regarding claim procedure, whenever the buyer becomes aware that an event has occurred from which there may arise an obligation of the seller as a result of the breach of a warranty, the buyer shall, as soon as practicable, give claim notice to the seller, and the buyer shall use reasonable endeavors to mitigate the losses. Moreover, according to Article 11.7, if a claim of the buyer for a warranty breach results from the liability of a third party, the buyer shall take such actions as it reasonably considers necessary to prevent or limit to the extent possible any loss or damage for which the seller may be liable, including taking such action to avoid, dispute or contest such liability as is reasonably practicable. According to Article 12.3 of the Model Contract, although any payment for warranty breaches shall be due immediately, the buyer shall use its reasonable endeavors to obtain postponement of payment when practicable, provided that the seller shall counter-guarantee without delay any required guarantees to the effect of such postponement. The parties to a share purchase agreement may also provide “best effort” duties in other instances of cooperation. For example, each party may be obliged by the contract in general terms to use its “reasonable endeavors to take, or cause to be taken, all actions, and to do, or cause to be done, all things necessary, proper or advisable and consistent with applicable Law, to perform its obligations under the agreement and to consummate the transactions contemplated as soon as reasonably practicable.”¹⁸⁷¹

In the practice of share purchase agreements, the representation and warranties are sometimes preceded by the words “as far as the seller is aware” or “to the best knowledge of the seller”.¹⁸⁷² The sellers often take the position that they cannot provide unqualified representations with respect to matters that, they claim, are beyond their control.¹⁸⁷³ The use of such expressions can be frequently found in the representations and warranties in such areas as environmental matters, compliance with laws, validity and renewals of permits and authorizations and intellectual property.¹⁸⁷⁴ Similar to “best efforts” obligations, the inclusion

Building Law Reports 1; HL affirming (1978) 11 BLR 29, CA, the Court of Appeal stated that: “We see no good reason... for not importing an obligation as to reasonable fitness for purpose into these contracts or for importing a different obligation in relation to design from the obligation which plainly exists in relation to materials.”

¹⁸⁷¹ Article 6.1 (Consummation of Transactions) Execution version of a Share Purchase Agreement dated 12 June 2006, on file with the author

¹⁸⁷² The ICC Task Force tried to avoid these wordings, but noted in the Model Contract that if the seller feels that he must limit his responsibility with respect to matters which are not totally under his control or with respect to which he has no precise information, he should use such wordings. ICC Model Mergers & Acquisitions Contract 1 - Share Purchase Agreement, ICC Commission on Commercial Law & Practice, ICC Publication No. 656, 2004 Edition, at 37

¹⁸⁷³ Kuney, George W., To the Best of Whose Knowledge?, California Business Law Practitioner, (Spring 2007), at 58

¹⁸⁷⁴ ICC Model Mergers & Acquisitions Contract 1 - Share Purchase Agreement, ICC Commission on Commercial Law & Practice, ICC Publication No. 656, 2004 Edition, at 14. An example would read, “There is no Legal Proceeding now in progress or pending or, as far as any Seller is aware, threatened against the

of such expressions seeks to affect the conditions of liability of the seller for breach of a warranty or representation. Under those clauses, the seller does not guarantee the exactness of its knowledge with regard to the relevant representations or warranties. When an unqualified representation or warranty is given, the seller who makes the representation or warranty takes the risk of unknown, yet related facts. In contrast, when such expressions are used, the seller may not be exposed to liability for those facts, depending on the definition of “knowledge”. Thus, the “best knowledge” reference may shift the risk of loss resulting from unknown defects from the seller to buyer.

However, if the parties do not define what is meant by “knowledge” in the contract, it is not entirely clear whether the “best knowledge” reference should imply an absence of knowledge after a reasonable inquiry, or on the basis of what is at the time actually known to the seller. While some agreements define “knowledge” as actual knowledge without any investigation requirement, others define “knowledge” as the knowledge of an individual, who “could be expected to discover or otherwise become aware of [a particular] fact or other matter in the course of conducting a reasonably comprehensive investigation concerning the existence of such fact or other matter.”¹⁸⁷⁵ If a dispute arises, the decision maker is invited to take into account these definitions, which reflect an understanding of the parties that they are not fully aware of the facts covered by the representation or warranty and that the parties share the resulting risk in a certain manner, which has most likely also had an effect on, and been reflected in, the bargain and the agreed purchase price.¹⁸⁷⁶ If the contract does not define “knowledge,” the search for its meaning becomes contextual, and the decision maker should examine the risk allocation between the parties. On the one hand, the interpretation of “knowledge” in such clauses as the actual knowledge of the seller implies that willful or at least actual blindness will protect the seller from liability, and the buyer wholly assumes the relevant risk.¹⁸⁷⁷ On the other hand, interpreting “knowledge” as involving an investigation requirement implies that the seller and buyer share the relevant risk on the basis of their respective duties of investigation since such an interpretation shifts some of the cost of “due diligence” from buyer to the seller, who has to take reasonable steps to investigate the true position to avoid liability for breach of relevant representation or warranty.¹⁸⁷⁸

Operating Company, any Person for whose acts or defaults the Operating Company may be vicariously liable, the Sellers, or the assets or Business, and there are no circumstances reasonably likely to give rise to a claim or Legal Proceeding.” Article 5.12.2 of a Share Purchase Agreement dated 12 June 2006, on file with the author

¹⁸⁷⁵ Committee on Negotiated Acquisitions, Model Asset Purchase Agreement with Commentary, ABA Section of Business Law, 2001, at 28-29

¹⁸⁷⁶ ICC Model Mergers & Acquisitions Contract 1 - Share Purchase Agreement, ICC Commission on Commercial Law & Practice, ICC Publication No. 656, 2004 Edition, at 14

¹⁸⁷⁷ *Conner v Hardee’s Food Sys.* (6th Cir 2003) 65 Fed Appx 19 (“Under Tennessee law, in the absence of actual knowledge that a particular statement is false, statements disclosed with the qualifier “to the best of one’s knowledge” cannot give rise to a misrepresentation claim.”)

¹⁸⁷⁸ *William Sindall plc v Cambridgeshire County Council* [1993] EWCA Civ 14 (“It is well established that a statement that a vendor is not aware of a defect in title carries with it an implied representation that he has taken reasonable steps to ascertain whether any exists... This may require him, in the first instance, to examine his title deeds and other records, inspect the property, and obtain legal advice. If there is anything to put him on inquiry as to the existence of a defect, he may have to pursue the matter further by questioning others, or examining their documents... the answer “Not so far as the Vendor is aware” represents not merely that the vendor and his solicitor had no actual knowledge of a defect, but also that they have made such investigations as could reasonably be expected to be made by or under the guidance of a prudent conveyancer.”)

The interpretation of clauses containing a reference to “best efforts” or its variants is a difficult issue as they are not always used by the parties in contracts in full knowledge of the consequences of their choice of terminology under the relevant rules of interpretation.¹⁸⁷⁹ These clauses may give rise substantial ambiguity as to the required level of performance of the relevant obligation. Thus, the parties usually try to provide specific examples and combine them with the standard of “best efforts”.¹⁸⁸⁰ These examples both specify certain instances of required behavior and guide the decision maker in interpreting the standard in order to resolve the ambiguity with regard to unspecified instances of required conduct in the form of residual contractual obligations.

2. Arbitral Decision Making

The national legal systems make a distinction between strict and fault-based liability in relation to the default regime of contractual liability for non-performance; in particular, civil law systems opting for fault-based liability in contract law while common law systems opting for strict liability. Under the national legal systems, the questions as to the conditions of liability and burden of proof are traditionally answered on the basis of whether the fault-based or strict liability governs the particular contract. However, it follows from principles of *pacta sunt servanda* and freedom of contract that the parties are able to regulate the intensity of the obligations undertaken in the contract thereby varying the default regime of contractual liability regime within certain limits. The effect of such variations on the issues of contractual liability of the parties should be taken into account by the ex post decision maker applying *lex mercatoria*. Consequently, the decision maker may primarily rely on the intentions and expectations of parties, and determine their risk allocation with regard to the performance of a particular obligation on the basis of its characterization as an undertaking to achieve a certain result or to use one’s best efforts.

It is argued that the “best efforts” clauses in international contracts constitute the common denominator between the opposing national legal systems by bringing the French distinction between obligation de moyens and de resultat closer to the legal systems in which it is not practiced and smoothing away the opposition between strict and fault-based liability in contract law.¹⁸⁸¹ In essence, the national legal systems recognize and give effect to the intensity of the obligations undertaken in a contract. Many legal systems do not opt exclusively for fault liability or strict liability in contract law, but often adopt a more nuanced approach, which utilizes intermediate solutions such as reversing the burden of proof, using an objective standard of care and diligence, and distinguishing between different types of

¹⁸⁷⁹ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 226

¹⁸⁸⁰ For example FIDIC Sub-Clause 4.15: “The Contractor shall use reasonable efforts to prevent any road or bridge from being damaged by the Contractor’s traffic or by the Contractor’s Personnel. These efforts shall include the proper use of appropriate vehicles and routes.” Another and more detailed example: “The contractor shall use every reasonable means to prevent any of the highways or bridges communicating with or on the routes of the Site from being damaged or Injured by any traffic of the Contractor or any of his Subcontractors and in particular shall select routes, choose and use vehicles and restrict and distribute loads that any such extraordinary traffic as will inevitably arise from the moving of plant and material from and to the Site shall be limited as far as reasonably possible and so that no unnecessary damage or injury may be occasioned to such highways or bridges.” Cited by Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 193

¹⁸⁸¹ Chappuis, Christine, *Provisions for Best Efforts, Reasonable Care, Due Diligence and Standard Practice in International Contracts*, *International Business Law Journal*, (2002), at 297

contracts.¹⁸⁸² However, due to the diverse backgrounds and self-referential legal structures of the national legal systems, which give rise to the divergent formal consolidations of similar instances, the parties may not be in a position to expect their formulation of best efforts obligations will lead to the same conclusions as to the conditions of liability and burden of proof under different national legal systems. For instance, some “best efforts” obligations can be considered as absolute undertakings practically leading to strict liability or presumption of fault, such as the contractors’ obligation to design in a construction contract under English law, the considerations of joint maximization volume under US law, and the parent company’s obligation in letters of comfort under French law.

Pursuant to the basic principles of *pacta sunt servanda* and freedom of contract, the rules of national legal systems, which determine the conditions of liability and burden of proof, should be considered by the decision maker applying *lex mercatoria* as part of the bargain if they are included by the parties in the articulated rules. However, under *lex mercatoria*, the questions of the conditions of liability and burden of proof are also matters of interpretation of contract, and require the decision maker to determine the common intention of the parties as to the intensity of contractual obligations, by exercising a contextual approach. Moreover, the decision maker should consider the intensity of residual obligations on the basis of the risk allocation and the reasonable expectations of the parties to a particular contract, in the supplementation of contract with individualized terms, which precedes the application of the default rules chosen by the parties.

a. Interpretation of Best Efforts Obligations

In the interpretation of the contract, the formulation of contractual clauses as to the intensity of obligations is not only relevant to the conditions of liability for non-performance, but also indicates the scope of contractual rights, obligations and risk allocations. In ICC Case No 7639, the arbitral tribunal considered the formulation of contractual clauses and the principles of good faith and *pacta sunt servanda*, as general principles of equity under the applicable Qatari law, to determine the intensity of obligations and extent of rights of the parties. On those bases, the arbitral tribunal gave effect to the reasonable expectations in compliance with the free will of both parties as to the allocation of risks and with the abstract considerations of trade usage in the relevant field. The dispute arose from a sponsorship agreement between an Italian contractor and a Qatari engineering company, whereby the latter undertook to become the “sponsor” of the contractor, and to use its “best endeavours” to assist the contractor in the award of projects for works in Qatar by an employer and, if such contracts were to be awarded, the contractor undertook to pay the sponsor a fixed percentage of the original contract value. The agreement was governed by the law of Qatar. It was to remain effective for one year and could be renewed upon one-month written notice. Several weeks before the end of the first year, the contractor informed the sponsor that it did not wish to renew the agreement and the agreement expired. The agreement contained a “Duration Clause”, which provided that, notwithstanding its expiry, its provisions would continue to apply to any projects that may have been awarded pursuant to its provisions. Approximately one and a half years after the expiry of the agreement, two contracts were awarded by the employer to the contractor. A dispute arose between the sponsor and the contractor regarding the sponsor’s entitlement to remuneration for these contracts. In the arbitral proceedings, the sponsor argued that, despite the expiry of the agreement, it was entitled to remuneration under the Duration

¹⁸⁸² Grundmann, Stefan, the Fault Principle as the Chameleon of Contract Law: a Market Function Approach, *Michigan Law Review*, 107 (June 2009), at 1583

Clause for the award of the contracts, since both contracts had been awarded as a result of its efforts under the agreement.¹⁸⁸³

The tribunal noted that the sponsor accepted when signing the agreement, the risk of working and incurring expenses without receiving any consideration, if no contract was awarded to the contractor by the expiry date of the agreement under the “Obligation Clause”.¹⁸⁸⁴ The sponsor’s risk in question was stressed further by another clause, which allowed the contractor to decide whether or not to submit a bid, whether or not to keep in the running or withdraw it, whether or not to amend or revise, and whether or not to accept or refuse the award of a contract actually made by the employer. Thus, in the arbitral tribunal’s view, the sponsor not only undertook the risk of non-award of the contract, depending on the employer’s decision, but also of non-award depending on a decision to be made by the contractor alone. The sponsor accepted the risk of not being paid nor reimbursed at all in case of the negative decision of the contractor. Under the Duration Clause, the sponsor would be entitled to its consideration even if the award was made after the expiry of the agreement only if the award could be proved to have resulted from the sponsor’s efforts during the validity of the agreement.¹⁸⁸⁵ In this context, the tribunal considered that the sponsor was under the burden to prove that two contracts that were awarded by the employer to the contractor after the expiry of the term of the agreement were due to its positive efforts and labor exerted during the validity of the agreement. Considering that all the crucial events that lead to the awards took place after the expiry of the agreement and that there was no contractual intention in the agreement, which would entitle the sponsor to receive his consideration on the basis of his efforts exerted after the expiry of the agreement, the tribunal rejected the sponsor’s arguments. The tribunal examined the agreement in light of the mandatory provisions of the applicable national law, and did not find any rule that supported the sponsor’s claim for compensation.¹⁸⁸⁶

Although neither party requested, the tribunal decided to consider general principles of equity as part of its terms of reference, in its genuine and serious desire to be fair to both parties since, according to the tribunal, the principles of equity play a vital role in the operation of the applicable Qatari law. The tribunal also stated that it was motivated by a desire to achieve completeness and thoroughness in preparing its award. In essence, what the tribunal considered under the general principles of equity can be considered as an attempt to consolidate its conclusion with the established rules in order to accurately give effect to the reasonable expectations of the parties. Thus, the tribunal referred to the principle of good faith under Article 49 of the Civil and Commercial Law of Qatar, and to the principle of *pacta sunt servanda* under Article 48. On the basis of these provisions, the tribunal noted that the sponsor undertook to use its “best endeavours”, in performing its obligations and “it did not guarantee results.”¹⁸⁸⁷ Considering that the contractor never counterclaimed for damages for the sponsor’s failure to produce positive results, the tribunal assumed that the sponsor did use its best endeavors during the agreement, to achieve the objectives of the agreement. However, the sponsor accepted to be paid upon achieving successful results i.e. the contractor being awarded a tender, during the validity of the agreement. The tribunal considered whether it was

¹⁸⁸³ ICC Award in Case No. 7639, Yearbook Commercial Arbitration, (1998), at 66-67

¹⁸⁸⁴ *Ibid.*, at 67

¹⁸⁸⁵ *Ibid.*, at 68

¹⁸⁸⁶ *Ibid.*, at 69-75

¹⁸⁸⁷ *Ibid.*, at 76

fair and reasonable to stipulate that the duration of the agreement was restricted to one year, or whether it was fair and reasonable to deprive the sponsor of payment, unless the award was proved to have been made during the one year specified. The tribunal noted that the specified duration of the agreement was freely entered into, and both parties must have felt the said duration was reasonable for their expectations under the circumstances prevailing at the time the agreement was signed. According to the tribunal, the provision, which granted payment to the sponsor only if the award was achieved within a certain time, was also reasonable and not contrary to equitable principles since, in its abstract reasoning, this is a common provision in sponsorship as well as in other agency contracts of this type. The tribunal considered that it is a common trade practice internationally to make payment to sponsor dependent on positive results, such as an award of a tender. The tribunal stated that “this trade usage provides certainty in the substance as well as in the duration of an agreement. The contractual practice which seems to prevail in the area, in the opinion of the Tribunal, does not conflict with the principles of good faith, as construed in the Agreement under consideration.”¹⁸⁸⁸

The tribunal also referred to Article 54 of the Qatari Civil and Commercial Law, which extends the interpretation and meaning of words and expressions, beyond the usual or strict construction and their appropriate circumstances. However, the tribunal considered that the Obligations Clause and the Duration Clause in the agreement were not vague or uncertain or incapable of precise meaning, which would throw some doubt on the genuine intentions of the parties. The tribunal concluded that “The above-mentioned Clauses of the Agreement are the outcome of the free will of both parties and their use is in compliance with the specific trade usage in this field and with equity accepted in Qatari Sponsorship contracts” and found that the claimant’s claims were not well founded as there was no violation of justice or equity in the behavior of the contractor towards the sponsor.¹⁸⁸⁹

Even if the text of the contract does not contain a reference to “best efforts”, the decision maker may interpret the contract through a contextual approach to the effect that some obligations contained in the contract should be characterized as undertakings to use best efforts. In ICC Case No 9797, the arbitral tribunal, applying “the general principles of law and the general principles of equity commonly accepted by the legal systems of most countries” to the substance of the dispute, had recourse to the UNIDROIT Principles in interpreting the contract with regard to the “best efforts” undertakings. The dispute took place between, on the one hand, the member firms of one of two business units of Andersen Worldwide Organization, as the claimants, and, on the other hand, the member firms of the other business unit and Andersen Worldwide Société Coopérative (“AWSC”) as the defendants. The claimants argued that the defendant member firms breached their material obligations by competing with the claimants, causing marketplace confusion and misappropriating the Andersen Consulting name, and that AWSC, as an administrative organ, breached its obligations by having failed to coordinate the activities of member firms of the two business units and to implement guidelines to ensure compatibility among them. AWSC argued that, with minor exceptions, Member Firm Interfirm Agreements (“MFIFAs”), which were entered into between AWSC and member firms, did not impose an obligation on AWSC to coordinate.¹⁸⁹⁰

¹⁸⁸⁸ Ibid., at 77

¹⁸⁸⁹ Ibid., at 78

¹⁸⁹⁰ ICC Award No. 9797, July 28, 2000, Andersen Consulting Business Unit Member Firms vs. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative, World Trade and Arbitration Materials, 12-5 (2000), at 166

In the tribunal's view, the language of the organizational documents was not in accordance with AWSC's interpretation. The tribunal considered that member firm coordination was the cornerstone of the MFIFAs since, if adequate coordination were not well-founded and properly ensured in an organization comprised of more than one hundred member firms worldwide, cooperation would be seriously impaired. The tribunal considered that, according to the Paragraph 2.1 of the MFIFAs, a member firm appoints AWSC to arrange for the coordination of its professional practice on an international basis with that of the other member firms and legitimately expects its professional practice to be coordinated with that of the other member firms. The tribunal concluded that the explicit MFIFA provisions, interpreted in light of the purposes and policies set forth in the Preamble thereto and in the AWSC Articles and Bylaws, demonstrate that AWSC's essential obligation is to coordinate the member firms' diverse professional practices. According to the tribunal, those coordinating duties included specific functions, among others, developing compatible policies and professional standards for the member firms, developing annual operating plans to ensure the effective coordination of the member firms' practices and determining the appropriate scope of practice for the member firms. By referring to Article 5.1.4 of the UNIDROIT Principles, the tribunal found that the wording of these purposes, policies and functions indicated that AWSC must exercise its best efforts to ensure cooperation, coordination and compatibility among the member firms' practices.¹⁸⁹¹

The tribunal held that AWSC did not use its best efforts to ensure coordination, cooperation and compatibility among the practices of the member firms on the basis of two grounds. First, AWSC abandoned its responsibility to design and develop annual operating plans to assure the effective coordination of the practices of the member firms, which was explicitly stipulated in the MFIFAs.¹⁸⁹² Secondly, AWSC failed to take any course of action when the scope of practice conflict surfaced and extended. Although AWSC initially attempted to tackle the scope of practice conflict between the member firms by drawing internal guidelines for business unit cooperation, they were not properly implemented by AWSC and, under the pressing circumstances, the AWSC management was unable to agree on a course of action to address the scope of practice dispute or to draft a proposal for the consideration of the AWSC partners.¹⁸⁹³ According to the tribunal, "AWSC's failure to exercise its best efforts to coordinate the member firms' practices substantially deprived Claimants of the cooperation they were entitled to expect under the MFIFAs."¹⁸⁹⁴

The "best efforts" standards in the formulation of obligations under the contract, which is to be interpreted as a whole under *lex mercatoria*, indicate the burden of proof for establishing the liability for non-performance of those obligations. In the ICSID case between Joseph Charles Lemire and Ukraine, the claimant, a national of the United States, argued that the defendant had failed to make its best efforts to provide claimant with the licences for radio frequencies under the settlement agreement concerning the investment by the claimant of broadcasting stations in Ukraine. As to the applicable law, the tribunal held that since the parties, when negotiating the settlement agreement, incorporated extensive parts of the UNIDROIT Principles into their agreement, and included a clause which authorized the

¹⁸⁹¹ Ibid., at 167

¹⁸⁹² Ibid., at 173

¹⁸⁹³ Ibid., at 174-176

¹⁸⁹⁴ Ibid., at 184

tribunal to apply the rules of law the tribunal considers appropriate, the most appropriate decision was to submit the settlement agreement to “the rules of international law, and within these, to have particular regard to the UNIDROIT Principles.”¹⁸⁹⁵ The settlement agreement provided that, by May 15, 2000, the defendant was to use its best possible efforts to consider in a positive way the application of the claimant’s company to provide it with the licences for 11 radio frequencies. The tribunal noted that, the express terms of the provision required the defendant only to apply its best efforts, but not to achieve a result.¹⁸⁹⁶ The tribunal referred to Article 5.1.4 of the UNIDROIT Principles and stated that “For Claimant to establish a violation of this best efforts obligation, it is not sufficient to prove that by May 15, 2000 the 11 radio frequency licences had not been granted — the required test is that he produce evidence showing that Ukraine has failed to make such efforts as would be made by a reasonable government in the same circumstances.”¹⁸⁹⁷ The tribunal observed that of the 11 licences envisaged, six were granted by the State Committee before the deadline, another four within one month of the deadline and the last one within 2 ½ months of the deadline.¹⁸⁹⁸ The tribunal held that “these delays do not amount to a violation of Ukraine’s best efforts obligation. There is often a gap between political decision and bureaucratic compliance. Paragraph 3 of Clause 13(b) explicitly requires that “the granting of licences ... will be made in accordance with the requirements of Ukrainian legislation”. There is no evidence that Ukraine abated its pressure on the State Committee to perform. The State Committee issued the licences within time limits which are not unreasonable in the context of Ukrainian administrative practices.”¹⁸⁹⁹

It has been suggested that the use of word “best” in defining obligations by the parties requires the decision maker to take into account a subjective criterion, which depends on the capabilities of the promisor or the degree of efforts that it uses to carry on its own business, while the use of “reasonable” implies an objective criterion with reference to what will generally be considered necessary to be done in similar circumstances.¹⁹⁰⁰ However, the wording of these obligations should not be decisive for the decision maker’s determination of the required level of performance of such obligations since, as a matter of interpretation, the context of contract might ultimately yield different consequences under different circumstances.

The interpretation of the contract through a contextual approach, which combines subjective and objective considerations, was at the core of the reasoning of the arbitral tribunal in the *Ad hoc Arbitration between the Government of the United Kingdom of Great Britain and Northern Ireland, and the Government of the United States with regard to their best efforts obligations, which concerned user charges in airports*. In 1977, the Government of the United Kingdom of Great Britain and Northern Ireland, and the Government of the United States signed in Bermuda an agreement concerning user charges in airports (Bermuda 2). In 1979, British Airports Authority announced very large increases in user charges for the charging

¹⁸⁹⁵ *Joseph Charles Lemire v Ukraine*, (ICSID Case No. ARB/06/18) IIC 424 (2010) Decision on Jurisdiction and Liability, 14 January 2010, available at <http://www.unilex.info/case.cfm?id=1533>, at para. 111

¹⁸⁹⁶ *Ibid.*, at para. 154

¹⁸⁹⁷ *Ibid.*, at para. 155

¹⁸⁹⁸ *Ibid.*, at para. 157

¹⁸⁹⁹ *Ibid.*, at para. 159

¹⁹⁰⁰ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 217

year 1980/81, which had the effect of increasing the charges payable by the US carriers at Heathrow by 60 to 70 percent. Although, a settlement was reached in 1983 between the British Airports Authority and Secretary of State for Trade, on the one hand, and the international airlines on the other, the differences persisted between the Governments of the Contracting Parties to Bermuda 2 regarding the user charges. In 1988, the US Government requested ad hoc arbitration pursuant to Bermuda 2 with respect to “the continuing dispute ... concerning the user charges imposed by the British Airports Authority ... and the conduct of the British Government in relation thereto.”¹⁹⁰¹

Article 10 of Bermuda 2 provided that “(1) Each Contracting Party shall use its best efforts to ensure that user charges imposed or permitted to be imposed by its competent charging authorities on the designated airlines of the other Contracting Party are just and reasonable. Such charges shall be considered just and reasonable if they are determined and imposed in accordance with the principles set forth in paragraphs (2) and (3) of this Article, and if they are equitably apportioned among the categories of users. (2) Neither Contracting Party shall impose or permit to be imposed on the designated airlines of the other Contracting Party user charges higher than those imposed on its own designated airlines operating similar international air services. (3) User charges may reflect, but shall not exceed, the full cost to the competent charging authorities of providing appropriate airport and air navigations facilities and services, and may provide for a reasonable rate of return on assets, after depreciation. In the provision of facilities and services, the component authorities shall have regard to such factors as efficiency, economy, environmental impact and safety of operation. User charges shall be based on sound economic principles and on the generally accepted accounting principles within the territory of the appropriate Contracting Party.”¹⁹⁰² These obligations raised a number of major difficulties in interpretation, which were identified by the ad hoc tribunal as follows: (1) the correct interpretation of the expression “best efforts” in the context of Article 10(1)-(3); (2) whether the obligations in Article 10(1)-(3) are obligations of conduct only, or also of result; (3) whether Article 10(1)-(3) defines “just and reasonable” for the purpose of Article 10(1); (4) whether the tribunal should begin by considering whether the user charges were “just and reasonable” or by considering whether the UK government had used its “best efforts”.

The arbitral tribunal stated that “the 'best efforts' obligation incumbent on [the UK Government] under Art. 10(1) of Bermuda 2 cannot be regarded as a promise or guarantee on [the UK Government]'s part that user charges will in fact be 'just and reasonable'. Had that been the intention, the words 'use its best efforts to' would simply have been superfluous.” According to the tribunal, Article 10(1) of Bermuda 2 placed the parties under a continuous duty to do their best to ensure that the goals of that provision are attained, but that was not an absolute duty, since a party may be able to point to good reasons that explain why, if the charges imposed on the designated airlines of the other party were not just and reasonable, that was not due to any lack of required effort on its part. The tribunal held that the UK government's obligation to use its best efforts in relation to user charges imposed a positive duty to take all steps that were legally open to it. In the view of the tribunal, “a Party is entitled to recognise the normal margin of appreciation enjoyed by charging authorities in relation to the complex economic situation that is relevant to the establishment of charges.” However, the tribunal's reasoning reflected to some extent the consideration of “joint

¹⁹⁰¹ Government of the USA v. Government of the UK and Northern Ireland, Ad Hoc Award of 30 November 1992, Yearbook Commercial Arbitration, 19 (1994), at 33-34

¹⁹⁰² Ibid., at 34-35

maximization volume” when it stated that “the Party is obliged to use as much effort as it would if it had an unconditional interest of its own in ensuring that relevant user charges did not exceed what was just and reasonable (e.g. because the Party itself was going to have to meet the cost of the charges): if a Party uses less effort than it would then have used, it cannot claim to have used its best efforts.” Even so, the tribunal put a limit to that consideration on the basis of the objective approach of “diligence insurance”, and stated that “the 'best efforts' obligation does not require the taking of steps which a reasonable government in the position of the Party would reasonably have believed to be unnecessary in order to ensure that the user charges imposed on the designated airlines of the other Party did not exceed just and reasonable charges.”¹⁹⁰³

In relation to the question of whether the obligations in Article 10(1)-(3) were obligations of "conduct" or "result", the tribunal rejected any interpretation that would treat both paragraphs (2) and (3) of Article 10 as creating obligations of result. According to the tribunal, such an interpretation would relegate “best efforts” to minimal significance, since any non-conformity with those paragraphs would itself constitute a breach of Bermuda 2, irrespective of the efforts made by the party in question to ensure conformity, and the only circumstances in which a party’s best efforts could be relevant would be where the other party alleged that, even though the requirements of paragraphs (2) and (3) were satisfied, the first party had not used its best efforts to ensure that charges were equitably apportioned among the categories of users.¹⁹⁰⁴ The tribunal concluded that “paragraph (2), as well as being relevant to the characterization of charges as just and reasonable for the purposes of paragraph (1), also imposes an independent mandatory obligation and is in this respect an obligations of result.” According to the tribunal, Article 10(2) was not subject to the qualification of “best efforts” and imposed an obligation of result with respect to non-discrimination against the airlines of the other contracting party, according to which, user charges could not be just and reasonable unless they were set in accordance with the condition laid out in Article 10(2).¹⁹⁰⁵ Thus, the tribunal’s reasoning in this regard was similar to that of the *Rhodia* decision of the English court, which held that where the contract actually specified that certain steps had to be taken as part of the exercise of reasonable endeavours, those steps would have to be taken, even if that could be said to involve the sacrificing of a party’s commercial interests.¹⁹⁰⁶

By contrast, the tribunal stated that “paragraph (3) of Art. 10 is solely concerned to lay down criteria for the characterization of charges as just and reasonable for the purposes of the “best efforts” obligation contained in paragraph (1) and is therefore relevant only to the content of the obligation of conduct imposed by that paragraph.”¹⁹⁰⁷ Given that each party’s interest is in the user charges imposed on its own designated airlines when they are using airport facilities in the territory of the other party, the tribunal discarded an interpretation of paragraph (3) as creating obligations independent of paragraph (1) since, because of the unlimited wording of paragraph (3), those obligations would be required to be performed for the benefit of not only the other party’s designated airlines, but also the first party’s own airlines and third countries’

¹⁹⁰³ Ibid., at 36

¹⁹⁰⁴ Ibid., at 38

¹⁹⁰⁵ Ibid., at 39

¹⁹⁰⁶ *Rhodia International Holdings Ltd v Huntsman International LLC* [2007] EWHC 292 (Comm)

¹⁹⁰⁷ *Government of the USA v. Government of the UK and Northern Ireland*, Ad Hoc Award of 30 November 1992, Yearbook Commercial Arbitration, 19 (1994), at 38

airlines.¹⁹⁰⁸ Thus, despite its apparently imperative drafting, Article 10 (3) was not interpreted by the tribunal to that effect, since otherwise the evidently intended obligation to use no more than best efforts would have been effectively transmuted into an absolute obligation of result. Considering the function of Article 10 (3) as purely definitional, the tribunal held that Article 10 (3), together with the “equitable apportionment” condition contained in Article 10 (1) and the mandatory condition contained in Article 10 (2), provided a complete definition of “justness and reasonableness” of charges. Thus, the tribunal rejected the UK government's submissions of other tests. The UK Government contended that the user charges at Heathrow compared favorably (or not unfavorably) with user charges at other airports elsewhere in the world. The tribunal held that such a finding would not relieve the tribunal of the need to consider whether the charges at Heathrow were just and reasonable under Article 10 (1)-(3), which contained its own definition of what constituted justness and reasonableness of user charges for the purposes of the parties’ best efforts obligation.¹⁹⁰⁹ The tribunal also noted that the UK Government suggested no alternative, other than international comparability, to the principles referred to in Article 10 (1)-(3), for the purpose of characterizing charges as just and reasonable, and the US Government contended that there was no alternative for that purpose.¹⁹¹⁰

As to the question of whether the correct starting point should be the “best efforts” of the UK Government or whether the results were “just and reasonable”, the tribunal stated that “In assessing whether ‘best efforts’ that a Party claims that it has made were sufficient, it will be necessary to consider whether a reasonable government, that was correctly interpreting the Treaty, would have believed that effort, beyond such (if any) as was deployed by the Party, was required. That question can be answered only in the light of all the relevant surrounding circumstances, including the actual user charges payable by the designated airlines of the other Party and those proposed by the Party’s competent authority.”¹⁹¹¹ However, the tribunal underlined that what matters is not whether the result that the party had to use its best efforts to achieve was in fact achieved, but whether the party used its best efforts to achieve that result. According to the tribunal, Bermuda 2 was concerned with the position *ex ante* (as it was to be expected when the relevant charges were imposed), and not *ex post* (as it turned out to be in the event). Thus, in answering the question of performance or non-performance of best efforts obligations, the arbitral tribunal decided to start with the direction and sufficiency of the British Government’s efforts, rather than the just and reasonable quality of the actual charges, but, in the course of appraising the direction and sufficiency of those efforts, the tribunal was to examine the actual charges imposed in the past and the results of their imposition and the charges to be imposed in the future and their likely results as they were to be expected in the light of past experience.¹⁹¹²

In a contract, in which a party does not tend to promise a perfect result, but promises to perform a degree of effort vaguely described in articulating a contractual obligation, both parties defer to the enforcement stage the uncertainty arising from the incorporation of such a vague standard in the formulation of the undertaking. In such cases, the control of uncertainty is delegated to the decision maker applying *lex mercatoria* in order for him to determine the

¹⁹⁰⁸ Ibid., at 39

¹⁹⁰⁹ Ibid., at 40

¹⁹¹⁰ Ibid., at 41

¹⁹¹¹ Ibid., at 42

¹⁹¹² Ibid., at 43

conditions of liability and burden of proof through an accurate reflection of the reasonable expectations of the parties. If the degree of the required efforts from the promisor is determined on the basis of the “joint maximization volume” as if the promisor and the promisee were united in a single firm, such references to “best efforts” in the contract become meaningless, to the extent that it places the uncertainty and burden of proof on the promisor of best efforts, who is required to prove that there was nothing significant it could have done to satisfy its obligation, as in *Falstaff* case. In such a case, the contracting parties’ choice of governance mechanism in the context of transactions governed through legal uncertainty is disregarded, since the vertical integration and contracts in the market can be considered as alternative modes for organizing the same transactions. Although the facts of the *Falstaff* case, which concerned the sale of a business, where part of the remuneration of the seller depended on future sales by the buyer of the products bearing the brand of target business, apparently required a more nuanced approach to the obligation of the buyer, the court disregarded the essence of a “best effort” obligation, which grants a form of autonomy of judgment to the promisor, by implying that even equal treatment of both brands would not have precluded liability, since the volume-based royalty attached only to the Ballantine label, and that *Falstaff*’s duty of best efforts required to something more than equal treatment of both labels but something less than economic suicide.¹⁹¹³

It is true that, in some contracts, the interests of the two parties in a best efforts obligation may conflict since, the promisor may wish to maximize its profit for its self-interest, while the promisee expects that the promisor should maximize the sum of its and the profits of promisee. However, when a party enters into a contract rather than opting for vertical integration, it has to choose its contracting partner on the basis of the latter’s competence in achieving a certain result. If the promisee settles for a best effort obligation under a particular bargain, it should be aware of the risk of monitoring problems, since it will not be able to discern the joint profits when it cannot monitor the costs of the promisor. These considerations should be relevant to the abstract reasoning of the decision maker controlling the uncertainty, as a form of risk allocation agreed by the parties, when they choose to become contractual partners on the basis of “best efforts” obligations rather than becoming partners in a firm through integration for organizing the same transaction.

This is reflected by the United States Court of Appeals for the Second Circuit in the case of *Zilg v. Prentice-Hall*. The court stated that the contract in question established a relationship between the publisher and author, which implies an obligation, derived both from the common expectations of parties and from their relationship, upon the publisher to make certain efforts in publishing a book that it had accepted notwithstanding the contractual clause about the publisher’s discretion.¹⁹¹⁴ The court took into account the competence of the publisher and contrasted the contract with the situation of an integrated firm by stating that “*Zilg*, like most authors, sought to take advantage of a division of labor in which firms specialize in publishing works written by authors who are not employees of the firm”, and “while publishers and authors have generally similar goals, differences in perspective and resulting perceptions are inevitable”.¹⁹¹⁵ The court added that although up-front payment to the author is a means of reconciling these differing viewpoints, the publishers will strongly

¹⁹¹³ Long, Lawrence S., *Best Efforts as Diligence Insurance: In Defense of "Profit Uber Alles"*, *Columbia Law Review*, 86-8 (Dec., 1986), at 1729-1730

¹⁹¹⁴ *Zilg v. Prentice-Hall* 717 F.2d at 679

¹⁹¹⁵ 717 F.2d at 679

prefer to have flexibility in reacting to actual marketing conditions according to their own experience in view of the uncertainty regarding the publication of most books.¹⁹¹⁶

Thus, in determining the level of required performance, the decision maker applying *lex mercatoria* should consider that, under a “best efforts” obligation, the promisor obtains from the bargain some autonomy in making judgment within the scope of its obligation. The promisee should prove that the promisor have failed in the exercise of this autonomy through incompetence or abuse, and the decision maker should examine the evidence relating to such a failure by taking into account the nature and purpose of the contract, as well as objective and subjective factors surrounding the contract through a contextual approach, rather than by considering the promisor as an employee of the promisee, and under the direct orders of the promisee to maximize its profits.

In ICC Case No. 5946, the Falstaff doctrine came up in the determination of the required level of performance under a “best efforts” obligation in an exclusive agency agreement concluded between a French company and US company in 1983. The US defendant, as sole and exclusive agent for the distribution and sale of two varieties of controlled wines bottled and supplied by the French claimant, undertook to use its best efforts to promote the sale of these wines within the contract territory. In 1985, the claimant terminated the agreement, arguing that the defendant failed to comply with the best efforts clause in the agreement since it had sold only an insignificant number of bottles bearing claimant’s own trade name. The claimant alleged that the defendant had concentrated its forces on selling wine bearing the defendant’s own “Brand X” label. During the arbitral proceedings, it was questioned whether “Brand X” wine was a subject matter of the agreement. The parties agreed that the agreement was to be construed in accordance with the laws of New York.¹⁹¹⁷

The sole arbitrator referred to the decision in the Falstaff case. The arbitrator noted that the substantial difference between the sales of Brand X and non-Brand X wine by the defendant would lead, as in the Falstaff case, to the conclusion that the defendant had failed to use its best efforts with respect to non-Brand X wine, if the agreement between the parties only covered non-Brand X wine. However, the arbitrator found that agreement encompassed Brand X wine as well as non-Brand X wine, and refused to examine the case under the Falstaff doctrine.¹⁹¹⁸ The arbitrator also referred to Section 2-306 (2) of the New York Uniform Commercial Code, which provides a term implied in law whereby the exclusive dealing of certain goods between the seller and the buyer imposes an implied obligation by the seller to use its best efforts to supply the goods and by the buyer to use its best efforts to promote their sale. However, the arbitrator held that the claim that the defendant violated this implied obligation by ordering insignificant quantity of non-“Brand X” wine was unfounded since the evidence showed that the agreement also encompassed “Brand X” wine.¹⁹¹⁹

After having held that the Brand X wine fell within the agreement and the alleged preference for the Brand X wine could not constitute a breach of the agreement, the arbitrator proceeded to determine whether the defendant failed to use its best efforts to promote wines subject to the agreement. Rather than looking at comparable levels of performance in other contracts in

¹⁹¹⁶ 717 F.2d at 680

¹⁹¹⁷ ICC (Final) Award in Case No. 5946, 1990, Yearbook Commercial Arbitration, 14 (1991), at 98

¹⁹¹⁸ *Ibid.*, at 100

¹⁹¹⁹ *Ibid.*, at 101

the relevant sector or similar objective factors, the arbitrator focused on the history of the defendant's performance under the contract, given that both parties relied on that evidence in their pleadings. The parties only disagreed as to how the performance between 1983 and 1985 should be accounted for, but both parties tried to use the very weak first half of 1984 in their favor: the claimant argued that the base period was the 1983 calendar year, according to which the decrease from 1983 to 1984 amounted to 130 percent, while the defendant stated that the base period should be the first full 12 months period, encompassing the second half of 1983 and the first half of 1984, which resulted in an increase of 7 percent in the quantities of wine ordered by the defendant. The arbitrator stated that the accurate approach would be to compare similar periods, which would mean that only the second half of 1983 and the second half of 1984 were to be compared, which resulted in a decrease of 34 percent.¹⁹²⁰ However, the arbitrator noted that the performance has to be seen in context, and held that, in light of the difficulties attributable to the claimant, the drop of performance of 34 percent from the second half of 1983 to the second half of 1984 did not amount to a failure of the defendant to use its best efforts to promote the wines subject to the agreement. The arbitrator stated that the burden of proof that the defendant failed to use its best efforts was "clearly" on the claimant. According to the arbitrator, while the claimant made a *prima facie* case for the second half of 1983 and 1984 that there was a non-significant drop of performance, the defendant also made a *prima facie* case that this drop in performance might have been caused by the difficulties attributable to the claimant, such as the claimant's inability to reproduce same labels, to guarantee continuity of shipment and stick to the same corporate names. The arbitrator dismissed the allegation of defendant's failure to use its best efforts on the ground that the claimant failed to overcome that *prima facie* case by showing that either one of those deficiencies alleged had no bearing on defendant's ability to promote claimant's wines in the contract territory.¹⁹²¹

b. Supplementation with Best Efforts Obligations

In supplementing a contract with individualized terms, the decision maker applying *lex mercatoria* should exercise its abstract reasoning in order to take into account the wide-spread use of the distinction between undertakings of "best efforts" or its variants and undertakings to achieve a certain result in international contracting practice and the recognition of such variations under the national legal systems. Such reasoning invites the decision maker to adopt a more refined approach in the supplementation of the contract with individualized terms, which takes into account the intensity of residual contractual obligations, in order to accurately give effect to the reasonable expectations of the parties. The residual contractual obligations may require a party to exert some efforts without bearing the risk of failure of its efforts, when the implied obligation requires a relatively complicated conduct, which involves a high degree of risk of failure in achieving a certain result, or a high degree of influence of the other party over its performance, such as the duty to use best efforts to agree or to obtain approvals from third parties or public authorities.

The arbitral tribunal in ICC Case No 8331 supplemented a memorandum of understanding (MOU), declaring the parties' intention to conclude certain agreements, with the implied undertaking to use best efforts to agree. Under the MOU, the parties committed themselves to conclude a contract for the sale of trucks and of spare parts and indicated in general terms their intention to come to an agreement for the setting up of an assembly plant for the

¹⁹²⁰ Ibid., at 107

¹⁹²¹ Ibid., at 108

production of the same type of trucks in the buyer's country. While the sales contract was actually concluded, the defendant refused to enter into negotiations for the setting up of the envisaged assembly plant arguing that the claimant lacked the necessary business organization for such a project.¹⁹²² The parties agreed that the arbitral tribunal shall apply UNIDROIT Principles. The claimant argued that the MOU was not a binding contract, but a letter of intent in which the parties agreed to consider carrying out some projects. According to the claimant, the parties were bound to negotiate in order to try to come to a final agreement on the different projects of the MOU, but the MOU did not bind the parties to execute those projects. The defendant contended that the MOU was its basic agreement with the claimant regarding a vast project for the assembly and the manufacturing of trucks, and the claimant failed to execute its part of the deal by not forming the joint venture agreed on in the MOU. According to the defendant, the UNIDROIT principles confirmed that the MOU was a binding agreement between the parties, since what had been left for negotiation were secondary little matters to be clarified by the parties in further discussions.¹⁹²³

The tribunal considered that the real issue was to establish the legal effect of the general description of the parties' intention, when such intention had not been translated into specific contractual obligations. The tribunal considered that when the parties agree upon general issues to be implemented by them at a later stage they cannot be released from their implied obligations to use their best efforts to ensure that such general issues become specific terms of contracts to be executed by the parties. The tribunal referring to Article 5.1.4(2) held that "the general description of the parties' intentions to reach agreements on certain issues contained in the MOU obligates the parties to exert their best efforts in order to have such intentions become defined terms of Contracts legally binding for each of them."¹⁹²⁴ The tribunal stated that "a party to an agreement that has freely chosen its counterpart for the business envisaged by both of them may not after the conclusion of said agreement invoke as a justification of the non-fulfillment of its obligation to exert its best efforts to have the business materialized that it has made a wrong choice in selecting the other party which, according to it, may not constitute a real counterpart." Thus, the tribunal held that "the Claimant breached its obligation to make its best efforts with the view to proceeding with the establishment of the assembly of Claimant vehicles in Iran in cooperation with the Respondent."¹⁹²⁵

In ICC Case No 10346, the arbitral tribunal considered the intensity of obligations in the supplementation of the contract with the duty of cooperation. The dispute concerned a contract for the sale of electricity by the claimant, a Colombian company, to defendant, another Colombian company. The agreement was never performed, because the contract was not registered in the public registry. The arbitral tribunal, applying Colombian law, found that the defendant had not performed the duty to collaborate that it was obliged to exercise jointly with the other party in order to adjust the provisions of the contract to the requirements of the public authority thereby obtaining the registration of the contract. In this regard, the tribunal took into account a contractual clause, which provided that that the registration was a joint task of the parties, Article 871 of the Colombian Commercial Code, and Article 5.1.3 of the UNIDROIT Principles.¹⁹²⁶ The tribunal considered that the undertaking to collaborate in

¹⁹²² ICC Award in Case No. 8331 of 1996, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 65

¹⁹²³ Ibid., at 66

¹⁹²⁴ Ibid., at 67

¹⁹²⁵ Ibid., at 68

¹⁹²⁶ ICC Award in Case No. 10346, December 2000, ICC International Court of Arbitration Bulletin, 12-2 (2001), at 108

relation to the registration of the contract in the public authority can be classified as an “obligation to try” (“obligación de medio”), which is an undertaking on the part of the debtor to use all diligence to obtain a result which it cannot guarantee, in contrast to “obligations to produce results” (“obligaciones de resultado”). The standard of required behavior for the obligations to try was described by the tribunal as the duty of the debtor to conduct itself in such a way as to use all reasonable means within its knowledge, experience, material resources, and diligence to obtain the result expected by the creditor but without guaranteeing that it will be achieved. In the tribunal’s view, the failure to comply with such a duty meant debtor’s fault, as an error of conduct which lead to the negative evaluation of the behavior of the professional. The tribunal stated that “Claimant has been successful in demonstrating that [the defendant] did not exercise due diligence in relation to the obligation to try to procure the registration of the contract in the [public registry], which is equivalent to having proved fault on the part of [the defendant]. This is one of the connotations of this kind of obligation, in contrast to the general rule on contractual liability where there is a presumption of fault on the part of the debtor in the event of failure to provide the service specified.”¹⁹²⁷

3. Concluding Remarks

The contractual liability under *lex mercatoria* is neither fault-based nor strict since, as the law of principled adjudication of contractual disputes, it does not provide such a distinction *ex ante*. Although, in the exclusive application of *lex mercatoria* to the substance of the dispute, the exercise of abstract reasoning on the basis of the international instruments enables the decision maker to derive such rules that are in favor of a regime of strict liability, those rules cannot be considered as established rules that are capable of overriding the regime of fault-based liability under the national rules applicable to the substance of the dispute pursuant to the established rules of conflict, due to the divergent and nuanced approaches of the national legal systems to the issue of contractual liability. Even so, the abstract “best efforts” considerations provide a flexible tool for the decision maker interpreting or supplementing the contract to determine the conditions of liability and burden of proof through an accurate reflection of the reasonable expectations of the parties in a particular case. Thus, the conditions of liability and burden of proof may be determined primarily by the intensity of contractual obligations on the basis of the reasonable expectations of the parties to a particular contract.

If the parties’ reasonable expectations require the decision maker to characterize an articulated or residual obligation, as one of “best efforts”, the promisee will have the burden of proving that the promisor has not satisfied the requirements of its obligation, so that the liability of the promisor may appear as fault-based. In determining the degree of required efforts, the decision maker applying *lex mercatoria* should consider that, under a “best efforts” obligation, the promisor obtains some autonomy of judgment within the scope of its obligation. The promisee should prove that the promisor have failed in the exercise of this autonomy through incompetence or abuse, and the decision maker should examine the evidence relating to such a failure by taking into account the nature and purpose of the contract, as well as objective and subjective factors surrounding the contract through a contextual approach. Thus, the decision maker will focus on the degree of efforts as would be made by a reasonable person of the same kind in the same circumstances, while emphasizing the subjective competence of the promisor, contractual context and the pleadings of parties in giving practical substance to the required degree of efforts. When the best effort standard is

¹⁹²⁷ Ibid., at 111

accompanied by specific instances of conduct in the contract, the decision maker should not only utilize them in determining the contents of best efforts obligations, but also consider whether they can be characterized as independent undertakings to achieve a result in accordance with the risk allocation agreed by the parties.

If the decision maker interpreting or supplementing the contract concludes that the obligation breached is an undertaking to achieve a certain result, then the promisee will only have to prove that the result have not taken place, and the promisor will bear the risks relating to its failure to perform the obligation, as though he has strict liability since he may not plead that he had done his best, subject to whether the default rules chosen by the parties or applicable pursuant to the established rules of conflict provide a rebuttable presumption of fault. However, in all cases, either party may provide such evidence that might affect the characterization of the obligation by the decision maker interpreting or supplementing the contract, and change the burden of proof and conditions of liability. Moreover, regardless of the intensity of its obligation, the promisor may be released from liability if it proves that the non-performance was due to the promisee's interference or unforeseen contingencies, subject to the conditions to be derived from the articulated or established rules in the particular case.

iii. Force Majeure

Regardless of whether its undertaking is characterized as one of best efforts or achieving a certain result, the promisor may be excused from liability for its non-performance if he proves that the performance of his obligations as agreed under the contract was rendered impossible by an event, which he could not have taken into account at the time of the conclusion of the contract, and he could not have avoided or overcome its consequences after the conclusion of the contract.¹⁹²⁸ This excuse is based on the doctrine of force majeure, which originates in Roman law concept of “Vis Major”. The concept of “Vis Major” was referred to as acts of God and limited to events of natural causes. The doctrine of force majeure has progressively been expanded by the courts of different national legal systems. However, the doctrine has not been accepted in the same way by the national legal systems. In abstract terms, force majeure refers to those situations outside the control of parties and which prevent them from performing the obligations as agreed under the contract.¹⁹²⁹ It has been defined as the law’s recognition of those situations “that without default of either party a contractual obligation has become incapable of being performed because the circumstances in which the performance is called for would render it impossible.”¹⁹³⁰ In this sense, the force majeure doctrine serves to mitigate the goal of strict contract enforcement with notions of justice and fairness.¹⁹³¹

1. Sources of Abstractions

a. National Laws

The force majeure excuse is expressly admitted by French law, under which it has been construed strictly, since either the obligor is freed when there is a total impossibility, or he has to perform the contract however onerous its performance has become.¹⁹³² Article 1147 of the French Civil Code, which regulates the conditions of contractual liability, provides that the debtor shall be ordered to pay damages by reason of the non-performance of a contractual obligation, whenever it does not prove that the non-performance comes from an external cause which cannot be imputed to him, although there is no bad faith on its part. Article 1148 provides an exemption from paying damages for an obligor who failed to perform as a result of force majeure or of a fortuitous event. Although the texts use different words to designate the concept, “external cause which cannot be imputed to the debtor” under Article 1147, and force majeure and fortuitous event under Article 1148, the French doctrine generally considers that these terms mean the same thing. According to the case law, these words can

¹⁹²⁸ Lando, Ole, Non-Performance (Breach) of Contracts, in in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 508

¹⁹²⁹ Treitel, G. H., *Frustration and Force Majeure*, London: Sweet and Maxwell, 1994, at 13

¹⁹³⁰ Puelinckx, A.H., Frustration, Hardship, Force Majeure, Imprévision, Wegfall der Geschäftsgrundlage, Unmöglichkeit, Changed Circumstances, *Journal of International Arbitration*, 3-2 (1986), at 50

¹⁹³¹ Rivkin, David R., *Lex Mercatoria and Force majeure*, in Emmanuel Gaillard (ed.), *Transnational Rules in International Commercial Arbitration*, ICC Publication No. 480/4, Paris, 1993, at 163

¹⁹³² Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1095

only be invoked if the obligor is free from fault, whereby absence of fault and exemption for non-performance due to force majeure are treated as equivalent.¹⁹³³

The case law derived three conditions for an event to constitute force majeure from the wording “external cause which cannot be imputed to the debtor”: the event must be exterior, unforeseeable, and irresistible. First, the event must occur outside the sphere for which the obligor is responsible. However, the French courts did not apply this condition in some cases, and recently, Cour de Cassation defined force majeure without mentioning this condition.¹⁹³⁴ Secondly, the event must be unforeseeable as of the time of the execution of the contract. In this determination, all of the circumstances surrounding the event, including its time and place, must be considered. It is generally admitted that the courts must, as in the case of appreciation of fault, base themselves on the standard of good family man, as adapted to the defendants’ activities and to their level of specialization.¹⁹³⁵ Finally, the event must be irresistible. According to the case law, if there is the impossibility of resisting the event, even if it could be foreseen, it constitutes in itself a case of force majeure.¹⁹³⁶ As in the requirement of unforeseeability, the test of irresistibility is primarily an objective one, which permits some subjectivity.¹⁹³⁷

Under French law, the effect of force majeure is detailed by the case law. Where force majeure is established, the obligor does not have to perform its obligations and it is not liable for damages. When the impossibility of performance is merely temporary, and time is not of the essence of the contract, the contract is merely suspended. In the case of permanent impossibility to perform under reciprocal contracts, the contract as a whole dissolves and the parties are released from it due to the interdependence of obligations, subject to the possibility of partially maintaining the contract. In general, the courts accept that release of the obligor from its obligation to perform automatically entails cancellation of the contract, wholly or in part, by operation of law.¹⁹³⁸ An application for judicial termination of the contract is not necessary in the case of impossibility of performance, because when one party’s obligation becomes impossible through force majeure, this removes the cause of the other party’s obligations and the contract disappears retroactively for lack of cause, with consequential restitution and counter-restitution of money or property transferred under it. It is also accepted that where the specific restitution is not possible, the courts may order the party under the

¹⁹³³ Zweigert, Konrad & Hein Koetz, *An Introduction to Comparative Law*, translated by Tony Weir, Oxford University Press, 3rd rev. ed., 1998, at 500

¹⁹³⁴ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1096: On 14 April 2006, in two cases, the Assemblée plénière de la Cour de cassation defined force majeure as “an event which is unforeseeable on the conclusion of the contract and irresistible in its performance”.

¹⁹³⁵ Rivkin, David R., *Lex Mercatoria and Force majeure*, in Emmanuel Gaillard (ed.), *Transnational Rules in International Commercial Arbitration*, ICC Publication No. 480/4, Paris, 1993, at 175

¹⁹³⁶ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1098

¹⁹³⁷ Rivkin, David R., *Lex Mercatoria and Force majeure*, in Emmanuel Gaillard (ed.), *Transnational Rules in International Commercial Arbitration*, ICC Publication No. 480/4, Paris, 1993, at 176

¹⁹³⁸ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1101

obligation of restitution to pay the value of the performance in question at the time of its transfer.¹⁹³⁹ However, it is observed that the courts have occasionally preferred to rely on Article 1184 of the French Civil Code. Article 1184 provides for judicial termination of the contract on non-performance, and allows the courts to verify that the conditions of force majeure are fulfilled before the contract is retroactively terminated.¹⁹⁴⁰ It also grants the court the discretion to reduce or vary the creditor's obligation in order to take account of the reduced performance of the debtor, where the contract has been performed in part before the force majeure supervened, or where the force majeure does not wholly or permanently prevent performance.¹⁹⁴¹

Some legal systems construct the ideas underlying the force majeure doctrine around the concept of impossibility of performance. Under the traditional doctrine of impossibility of performance, the obligor is released from its contractual duty to perform if the impossibility occurred after formation of the contract and cannot be attributed to any kind of fault of the obligor. Many civil law systems recognize this excuse to the contractual liability, although the way the excuse is given effect varies considerably.¹⁹⁴²

German law, in general, approaches to this question by reference to the categories of impossibility. Where impossibility is only temporary, the contract is normally suspended. There is also a distinction between impossibility attributable or not attributable to the obligor.¹⁹⁴³ The doctrine of impossibility of performance was regulated in Section 275 of the German Civil Code of 1900. Under this provision, the obligor was released from its duty to perform to the extent that the performance becomes impossible after the conclusion of the contract as a result of a circumstance for which he is not responsible. After the reform of the rules of obligations of the German Civil Code that came into force in 2002, the new system is based on a general concept of breach of duty under Section 280, which is considered comparable to the general concept of non-performance under the CISG, the UNIDROIT Principles and the PECL.¹⁹⁴⁴ Accordingly, the questions of whether the breach was caused by an impediment or not become relevant only with regard to specific remedies under German law, and it does not matter, in principle, at the stage of determining non-performance whether the obligor was at fault or otherwise responsible for not overcoming the relevant impediment.

¹⁹³⁹ Bell, John, Sophie Boyron & Simon Whittaker, *Principles of French law*, Oxford University Press, 2nd ed., 2008, at 443

¹⁹⁴⁰ *Ibid.*, at 347

¹⁹⁴¹ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 207

¹⁹⁴² Brunner, Christoph, *Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration*, Kluwer Law International, 2009, at 77

¹⁹⁴³ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe): 5*, Hart Publishing; 2nd Revised edition, 2010, at 1102

¹⁹⁴⁴ Bonell, Michael Joachim, *An International Restatement of Contract Law: the UNIDROIT Principles of International Commercial Contracts*, Transnational Publishers, 3rd ed., 2005, at 268; Schlechtriem, Peter, *The German Act to Modernize the Law of Obligations in the Context of Common Principles and Structures of the Law of Obligations in Europe*, Oxford U Comparative L Forum, 2 (2002), at ouclf.iuscomp.org, text after note 31

After the reform, Section 275 of the German Civil Code largely sets aside the requirement that the impossibility must not be imputable to the obligor.¹⁹⁴⁵ Section 275 (1) only deals with the question whether or not the obligor can be forced to perform, and if performance is impossible, it should not be ordered to perform, regardless of the reason of impossibility. Thus, it provides that performance cannot be obtained in so far as it is impossible for the obligor, in the sense of subjective impossibility, or for everybody, in the sense of objective impossibility. Section 275 (2) recognizes the cases of “practical impossibility”, in which the obligor may refuse to perform if performance will cause the obligor an effort which, contrary to the requirement of good faith and fair dealing, is disproportionate to the interest of the obligee in getting the performance. In the latter cases, the question of whether the breach of duty is attributable to the obligor becomes relevant to some extent, since Section 275 (2) provides that, when it is determined what efforts may reasonably be required of the obligor, it must also be taken into account whether he is responsible for the obstacle to performance. Finally, pursuant to Section 275 (3), the obligor may refuse a performance of a personal character provided that, when the obstacle to the performance of the obligor is weighed against the interest of the obligee in performance, performance cannot be reasonably required of the obligor.

Section 275 does not require the event causing impossibility to be unforeseeable.¹⁹⁴⁶ However, as Section 276 allows for stricter liability in cases of a guarantee or an assumption of risk by the obligor, which can be derived from the content of the contract, it is argued that this flexibility enables the interpretation of impossibility under German law to reflect the conditions of force majeure excuse: the obligor must not have assumed the relevant risk, the non-performance must be due to an impediment beyond its control, the obligor could not reasonably foresee the impediment at the time of contracting, and he could not reasonably avoid or overcome it or its consequences.¹⁹⁴⁷ Thus, in this view, the decisive criterion should be whether the obligor has assumed a particular risk, instead of the distinctions among various categories of impossibility.

The legal consequence of Section 275 of the German Civil Code is the exclusion of a claim for specific performance, regardless of the reason of impossibility. In cases of impossibility, the obligee may terminate the agreement for non-performance under Section 323, even if the non-performance was not the obligor’s fault. Section 326 (5) provides that although Section 323 may apply to the cases of impossibility, it is not necessary to fix a period of time to terminate the contract. Moreover, pursuant to Section 326 (1) and (2), the obligee will be released from the obligation to make a counter-performance, whether or not the impossibility was caused by the obligor, unless the obligee itself is responsible for the impossibility. Thus, the obligee does not have to exercise his right to terminate the contract for non-performance under Section 323, since he is automatically released from his obligation under Section

¹⁹⁴⁵ Brunner, Christoph, *Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration*, Kluwer Law International, 2009, at 82

¹⁹⁴⁶ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1103

¹⁹⁴⁷ Brunner, Christoph, *Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration*, Kluwer Law International, 2009, at 86; Schlechtriem, Peter, *The German Act to Modernize the Law of Obligations in the Context of Common Principles and Structures of the Law of Obligations in Europe*, *Oxford U Comparative L Forum*, 2 (2002), at ouclf.iuscomp.org, text after note 45

326.¹⁹⁴⁸ The ipso iure exclusion of the obligee's duty to perform in cases of impossibility is considered as the functional equivalent to a right of termination.¹⁹⁴⁹ According to Section 326 (4), in cases where the obligee has already performed an obligation, from which he was released under Section 326, it may claim restitution of the benefits transferred, pursuant to Section 346.

The obligor's fault will be relevant to its liability for damages under Section 280: if the obligor caused the impossibility, he will be liable in damages. Likewise, according to Section 283, where the obligor is excused from rendering specific performance due to impossibility, the obligee may demand damages in lieu of performance, if the requirements of Section 280 (1) are satisfied. The second sentence of Section 280 (1) excludes liability when the obligor is not responsible for non-performance. Under Section 285 (1), whenever the obligor is excused from performing on the ground that performance is impossible, the obligee may demand surrender of what has been received by the obligor as substitute or an assignment of the substitute claim. Section 285 (2) provides that if the obligee demands damages in lieu of performance as well as surrender of substitute, the damages are reduced by the value of the reimbursement or the claim to reimbursement he has obtained. Moreover, pursuant to Section 326 (3), if the obligor claims what the obligee has received as a substitute, the obligee is obligated to perform its counter-performance, but the latter is diminished insofar as the value of the substitute is lower than the value of the performance due.

Common law traditionally treats contracts in absolute terms of risk allocation between the parties. Thus, originally in common law, the supervening events provided no excuse for non-performance and the concept of force majeure was not a traditional common law doctrine.¹⁹⁵⁰ However, the courts have gradually admitted doctrines of impossibility, impracticability and frustration, which take into account such events that occur after the contract was concluded and make performance of contract impossible, illegal, or something radically different from that which was in the contemplation of the parties at the time of contract conclusion, but these doctrines presently operate within very narrow confines.¹⁹⁵¹

Under English law, the doctrine of frustration was established in 1863 in the case of *Taylor v. Caldwell*, where the court employed the concept of an implied term in fact as the basis of a doctrine of impossibility of performance.¹⁹⁵² This theory was later criticized due to the difficulty or impossibility in determining the parties' implied intentions at the time of contracting, on the basis of the officious bystander test, since had that bystander pointed out

¹⁹⁴⁸ Zimmermann, Reinhard, *The New German Law of Obligations: Historical and Comparative Perspectives*, Oxford University Press, 2005, at 68

¹⁹⁴⁹ *Ibid.*, at 69

¹⁹⁵⁰ In an old English case, *Paradine* sued for three years of rent from Jane who had been deprived of use of the land for three years due to the invasion of the relevant land during the English Civil War. The court held that Jane was liable for the rent. *Paradise v. Jane*, (1647) Aleyn 26, [1647] EWHC KB J5, 82 ER 897 This decision reflects the doctrine of "absolute contract", where an "accident by inevitable necessity" cannot release the obligor because he could have guarded against it in the contract. The judgments in the later cases of *Taylor v. Caldwell* 122 ER 309, [1863] EWHC QB J1, 3 B & S 826 and *Krell v. Henry* 2 K.B. 740 (1903) mitigated this absolutist doctrine.

¹⁹⁵¹ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 308

¹⁹⁵² *Taylor v. Caldwell* 122 ER 309, [1863] EWHC QB J1, 3 B & S 826: "The principle seems to us to be that, in contracts in which the performance depends on the continued existence of a given person or thing, a condition is implied that the impossibility of performance arising from the perishing of the person or thing shall excuse the performance."

to the parties the supervening event that would take place in the future, the parties could have sought to insert reservations or qualifications in regulating the effects of such an event.¹⁹⁵³ Lord Radcliff, in the case of *Davis Contractors Ltd v. Fareham UDC*, highlighted the “logical difficulty in seeing how the parties could even impliedly have provided for something which *ex hypothesi* they neither expected nor foresaw” and emphasized the legal effect of frustration, which “does not depend on their intention or their opinions, or even knowledge, as to the event.” Thus, he stated that “frustration occurs whenever the law recognizes that without default of either party a contractual obligation has become incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract.”¹⁹⁵⁴ Since it is established that the courts will not assist a party who is trying to escape from a bad bargain, the doctrine of frustration cannot be invoked simply because the performance has become more onerous, but only where the supervening event radically or fundamentally changes the nature of performance.¹⁹⁵⁵ The contracting parties are expected to foresee many possibilities and guard against them in defining their obligations under the contract. Thus, in determining whether a radical change in the obligation exists, the courts will ask what the original contract required of the parties and then consider whether the frustrating event has rendered performance ‘radically different’ from that which was originally envisaged.¹⁹⁵⁶

There are a number of limitations upon the scope of the doctrine of frustration under English law. First, if the contract contains an express clause for the occurrence of the alleged frustrating event, the contract will not be considered as subject to the doctrine of frustration.¹⁹⁵⁷ Thus, the force majeure clauses may exclude the operation of doctrine of frustration, because the contract, on its proper interpretation, will be held to have covered and made its own provision for the frustrating event.¹⁹⁵⁸ The courts have generally interpreted these clauses narrowly.¹⁹⁵⁹ Nevertheless, it is suggested that the courts are more willing to enforce a force majeure clause than to invoke the doctrine of frustration since a force majeure clause, agreed by the parties, forms an essential part of their bargain, and the court’s role in

¹⁹⁵³ *Ocean Tramp Tankers Corp. v V/O Sovfracht (The Eugenia)* [1964] 2 QB 226 at 238, *National Carriers Ltd v Panalpina (Northern) Ltd* [1981] 1 All ER 161

¹⁹⁵⁴ [1956] AC 696

¹⁹⁵⁵ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 309; *Pioneer Shipping Ltd v BTP Tioxide Ltd ('The Nema' (No 2))* [1982] AC 724, at 752 Lord Roskill stated with regard to frustration, that such a doctrine was “not lightly to be invoked to relieve contracting parties of the normal consequences of imprudent bargains.”

¹⁹⁵⁶ Stone, Richard, & Ralph Cunnington, *Text, Cases & Materials on Contract Law*, Routledge-Cavendish, 2007, at 914; Lord Denning stated that “To see if the doctrine applies, you have first to construe the contract and see whether the parties have themselves provided for the situation that has arisen. If they have provided for it, the contract must govern. There is no frustration. If they have not provided for it, then you have to compare the new situation with the situation for which they did provide. Then you must see how different it is. The fact that it has become more onerous or more expensive for one party than he thought is not sufficient to bring about a frustration. It must be more than merely more onerous or more expensive. It must be positively unjust to hold the parties bound. It is often difficult to draw the line. But it must be done, and it is for the courts to do it as a matter of law”. *Ocean Tramp Tankers Corp. v V/O Sovfracht (The Eugenia)* [1964] 2 QB 226, at 239-240

¹⁹⁵⁷ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 314-315: In cases of supervening illegality, which occurs after the conclusion of the contract, the operation of doctrine of frustration cannot be excluded by express terms of the contract due to the overriding consideration of public policy

¹⁹⁵⁸ *Ibid.*, at 315

¹⁹⁵⁹ Stone, Richard, & Ralph Cunnington, *Text, Cases & Materials on Contract Law*, Routledge-Cavendish, 2007, at 935

relation to such a clause is confined to interpreting and giving effect to it without making a new contract for the parties or imposing an outcome irrespective of their wishes.¹⁹⁶⁰ Secondly, the doctrine of frustration does not apply to a foreseeable event, which is within the contemplation of the parties at the time of contracting. The test of foreseeability is based on objective considerations, “any person of ordinary intelligence would regard as likely to occur.”¹⁹⁶¹ However, the approach, which required unforeseeability as a condition for the doctrine of frustration, was challenged by Lord Denning in *The Eugenia*, who considered that even if the event was foreseeable and the parties did not make a provision for it in the contract, the doctrine of frustration may apply provided that the basic criterion of something radically different from that which was the parties’ contemplation is satisfied.¹⁹⁶² Thirdly, a party cannot invoke the doctrine of frustration where the alleged frustrating event is caused by his own conduct, namely the cases of “self-induced frustration”. Thus, a party will only be entitled to rely on the doctrine of frustration if the frustrating event took place “without blame or fault” on its part.¹⁹⁶³ If a party wishes to argue that a frustrating event is self-induced by the other party it must prove it on the balance of probabilities.¹⁹⁶⁴

The legal consequence of frustration under English law is that the relevant contract is brought to an end automatically at the time of the frustrating event. There is a clear distinction between breach of contract and frustration, and thus, there is no notion of temporary frustration, which excuses performance for the time being.¹⁹⁶⁵ There were problems in relation to the remedial consequences of frustration since the decision in the case of *Chandler v Webster* in 1904, where it was held that the loss lay where it fell.¹⁹⁶⁶ This approach, under which the parties are excused from their future obligations but not from the obligations that existed prior to the time of the frustrating event, was deemed unsatisfactory due to the problems of unjust enrichment. The House of Lord’s decision in the case of *Fibrosa Spolka Akcyjna v Fairbairn Lawson Combe Barbour Ltd* changed the rule by allowing the money paid prior to the frustrating event to be recoverable upon a total failure of considerations, which arises when the party seeking for recovery has got no part of what he has bargained for.¹⁹⁶⁷ However, the ‘total failure’ requirement in the decision of *Fibrosa* represented a significant limitation on the availability of restitution since if the other party has provided any part of the bargained-for performance, no matter how small, recovery would not be possible.

¹⁹⁶⁰ McKendrick, Ewan, *Force Majeure Clauses: The Gap between Doctrine and Practice*, in A. Burrows & E. Peel, (eds.), *Contract Terms*, Oxford University Press, 2007, at 239; In this regard, it is pointed out that the rejection of the implied term theory in the doctrine of frustration was probably overstated. Given that the force majeure clauses can regulate the effect of unforeseen events, it is questioned why it cannot be done by one that is implied. Nevertheless, it is admitted that the implied term theory obscures what the courts are actually doing: the courts actually seek to determine whether the supervening event has such an effect on the contract that it is unfair to hold parties to their bargain, in the absence of fault and of any assumption of the risk by either party. Stone, Richard, & Ralph Cunnington, *Text, Cases & Materials on Contract Law*, Routledge-Cavendish, 2007, at 912

¹⁹⁶¹ Treitel, G. H, *The Law of Contract*, Thomson/Sweet & Maxwell, 11th ed., 2003, at 902

¹⁹⁶² *Ocean Tramp Tankers Corp. v V/O Sovfracht (The Eugenia)* [1964] 2 QB 226, at 239

¹⁹⁶³ *J Lauritzen AS v Wijsmuller BV (The Super Servant Two)* [1990] 1 Lloyd’s Rep 1

¹⁹⁶⁴ Stone, Richard, & Ralph Cunnington, *Text, Cases & Materials on Contract Law*, Routledge-Cavendish, 2007, at 927-928

¹⁹⁶⁵ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1106

¹⁹⁶⁶ [1904] 1 KB 493

¹⁹⁶⁷ [1943] AC 32

Moreover, the availability of restitution was limited in that the expenditure that may have been incurred by the other party in relation to the contract is not taken into account.¹⁹⁶⁸ The Law Reform (Frustrated Contracts) Act 1943 was enacted as a response.¹⁹⁶⁹ The Act provides a more flexible form of restitutionary relief and the judicial discretion to make adjustments within the general framework of recovery for unjust enrichment.¹⁹⁷⁰ The Act provides, in the section 1 (2), that moneys paid prior to the frustrating event are recoverable and not confined to total failure of consideration, and that the party to whom the payment was made may be entitled to set off against such payment expenses which he incurred in the performance of the contract prior to the frustrating event. Pursuant to the section 1 (3) of the Act with regard to the recovery of valuable benefits other than a payment of money, where one party has conferred to the other a valuable benefit prior to the frustrating event, he shall be entitled to recover a just sum which shall not exceed the value of the benefit which he has conferred upon the other party.

In the United States, the term “frustration” is limited to situations where it is possible to perform the contract, but performance would be senseless, i.e. frustration of purpose.¹⁹⁷¹ Instead, the term “impracticability” is the counterpart of the civil law concepts of impossibility or force majeure. The doctrine of impracticability was first expressed in the case of *Mineral Park Land Co. v. Howard*, where the Supreme Court of California stated that “a thing is impossible in legal contemplation when it is not practicable.”¹⁹⁷² In the case, the defendants had contracted to remove a certain quantity of gravel from the plaintiff's land for a construction project, but took only half the agreed amount because the remainder of the gravel was under water. Performance of the contract was held “legally impossible” because the parties had not contemplated the removal of gravel from below the water level and it would have been 10-12 times as expensive for the defendants to remove the remaining gravel.

Section 261 of the Restatement (Second) of Contracts provides that “Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.” This provision is based on Section 2-615 of Uniform Commercial Code, which provides the doctrine of impracticability for the sale of goods as an excuse for the sellers' performance. Section 261 of the Restatement is broadly applicable to all types of impracticability and it “deliberately refrains from any effort at an exhaustive expression of contingencies”.¹⁹⁷³ There are three categories of cases where this general principle has

¹⁹⁶⁸ Stone, Richard, & Ralph Cunnington, Text, Cases & Materials on Contract Law, Routledge-Cavendish, 2007, at 939-940

¹⁹⁶⁹ Section 2(5) provides a list of contracts that are excluded from the scope of the Act. This includes charterparties for a particular voyage, contracts of insurance, and contracts falling within s 7 of the Sale of Goods Act 1979.

¹⁹⁷⁰ Stone, Richard, & Ralph Cunnington, Text, Cases & Materials on Contract Law, Routledge-Cavendish, 2007, at 952

¹⁹⁷¹ Perillo, Joseph M., Force Majeure and Hardship under the UNIDROIT Principles of International Commercial Contracts, in *Contratación internacional, Comentarios a los Principios sobre los Contratos Comerciales Internacionales del Unidroit*, Universidad Nacional Autónoma de México - Universidad Panamericana, 1998, at 111

¹⁹⁷² *Mineral Park Land v. Howard* 172 Cal. 289, 156 at 458 (1916)

¹⁹⁷³ Comment a on Section 261 of the Restatement (Second) of Contracts (1981) citing Comment 2 to Section 2-615 of the Uniform Commercial Code

traditionally been applied: supervening death or incapacity of a person necessary for performance (Section 262), supervening destruction of a specific thing necessary for performance (Section 263), and supervening prohibition or prevention by law (Section 264).

The doctrine of impracticability is essentially based on an enquiry of which party assumed the relevant risk. The Restatement (Second) of Contracts, following the rationale of Section 2-615 of the Uniform Commercial Code, states that the central inquiry is whether the non-occurrence of the circumstance was a “basic assumption on which the contract was made”, and “determining whether the non-occurrence of a particular event was or was not a basic assumption involves a judgment as to which party assumed the risk of its occurrence.”¹⁹⁷⁴ Thus, if a party undertakes to achieve a result irrespective of supervening events that may render its achievement impossible, his non-performance is a breach even if it is caused by such an event.¹⁹⁷⁵ Even absent an express agreement, a court may decide, after considering all the circumstances, that a party impliedly assumed an obligation to perform in spite of impracticability that would otherwise justify his non-performance.¹⁹⁷⁶ Whether a party has assumed the risk of loss arising from the event can also be determined on the basis of the foreseeability of the supervening event since the fact that the event was unforeseeable is deemed significant as suggesting that its non-occurrence was a basic assumption. However, the Restatement explains that the fact that the event was foreseeable, or even foreseen, does not necessarily compel a conclusion that its non-occurrence was not a basic assumption, since the parties may not have thought it sufficiently important a risk to have made it a subject of their bargaining.¹⁹⁷⁷

The courts ruled, in a series of cases involved contracts to ship goods, that the closing of the Suez Canal in 1956 was foreseeable to parties who relied on the canal route and the risk was undertaken by the obligor.¹⁹⁷⁸ In the case of *Glidden Co. v. Hellenic Lines Ltd.*, the United States Court of Appeals for the Second Circuit found, on the basis of the evidence, that in prior contracts with other similar transactions, Hellenic had sought and obtained a clause specifically excusing its performance in the event that the Suez Canal was closed. The court stated that “In its negotiations with Glidden, Hellenic urged that the charters include the same or a like provision, but Glidden, after consideration of the matter, rejected any such clause. Hellenic thereupon agreed to the charters without any frustration provision ... protecting the shipper against the eventuality ... In all likelihood the shipper did not suppose at the time of negotiations that the contract language excused his performance if the Suez Canal were closed, for there would then have been little reason to press for the inclusion of a specific clause.”¹⁹⁷⁹ Similarly, in *Eastern Air Lines, Inc v. Gulf Oil Corp*, the United States District Court for Southern District of Florida rejected Gulf’s impracticability defense, by observing that: “The record is replete with evidence as to the volatility of the Middle East situation, the arbitrary power of host governments to control the foreign oil market, and repeated interruptions and interference with the normal commercial trade in crude oil... oil has been

¹⁹⁷⁴ Restatement (Second) of Contracts (1981), Introductory Note on Ch. 11

¹⁹⁷⁵ Comment a to Section 261 of the Restatement (Second) of Contracts (1981)

¹⁹⁷⁶ Comment c on Section 261 of the Restatement (Second) of Contracts (1981); This is also reflected in Section 2-615 of the Uniform Commercial Code, which applies “Except so far as a seller may have assumed a greater obligation...”

¹⁹⁷⁷ Restatement (Second) of Contracts (1981), Introductory Note on Ch. 11

¹⁹⁷⁸ *Transatlantic Financing Corp. v. United States*, 124 U.S.App:D.C. 183, 363 F.2d 312 (1966)

¹⁹⁷⁹ 275 F.2d 253 (2d Cir. 1960), at 257

used as a political weapon with increasing success by the oil-producing nations for many years, and Gulf was well aware of and assumed the risk that the OPEC nations would do exactly what they have done.”¹⁹⁸⁰

The term “impracticability” is an all embracing term to describe the required extent of the impediment to performance. According to the Restatement Second Contracts, the term “impracticability”, which was also employed by Section 2-615(a) of the Uniform Commercial Code, has deliberately been preferred to the term “impossibility” because the doctrine is not limited to situations of absolute impossibility. It is explained that the performance may be impracticable because of the extreme and unreasonable difficulty, expense, injury, or loss, but a mere change in the degree of difficulty or expense due to such causes as increased wages, prices of raw materials, or costs of construction, unless well beyond the normal range, does not amount to impracticability, since it is this sort of risk that a fixed-price contract is intended to cover. Moreover, a party is expected to use reasonable efforts to surmount obstacles to performance, and a performance is impracticable only if it is so in spite of such efforts.¹⁹⁸¹

In *Transatlantic Financing Corp. v. United States*, the United States Court of Appeals for the District of Columbia Circuit explained the doctrine of impracticability enunciated by section 2-615 of the Uniform Commercial Code, as follows: “The doctrine ultimately represents the ever-shifting line, drawn by courts hopefully responsive to commercial practices and mores, at which the community's interest in having contracts enforced according to their terms is outweighed by the commercial senselessness of requiring performance. When the issue is raised, the court is asked to construct a condition of performance based on the changed circumstances, a process which involves at least three reasonably definable steps. First, a contingency -- something unexpected -- must have occurred. Second, the risk of the unexpected occurrence must not have been allocated either by agreement or by custom. Finally, occurrence of the contingency must have rendered performance commercially impracticable.”¹⁹⁸² Thus, the courts in the US have shown reluctance to uphold the defense of impracticability based on the ground of increased costs.

In *Maple Farms Inc. v. City School District of Elmira*, the Supreme Court of New York rejected the defense of impracticability in the performance of a fixed-price contract under a milk supply contract as a result of 23% increase in price of raw milk. The court found that the contingency causing the increase of the price of raw milk was not totally unexpected since “any business man should have been aware of the general inflation in this country during the previous years and of the chance of crop failures.” The court explained that “the very purpose of the contract was to guard against fluctuation of price of half pints of milk as a basis for the school budget. Surely had the price of raw milk fallen substantially, the defendant could not be excused from performance. We can reasonably assume that the plaintiff had to be aware of escalating inflation. It is chargeable with knowledge of the substantial increase of the price of raw milk from the previous year's low. It had knowledge that for many years the Department of Agriculture had established the price of raw milk and that that price varied. It nevertheless entered into this agreement with that knowledge. It did not provide in the contract any exculpatory clause to excuse it from performance in the event of a substantial rise in the price

¹⁹⁸⁰ 415 F. Supp. 429, 441 (S.D.Fla. 1975) at 441-442

¹⁹⁸¹ Comment d on Section 261 of the Restatement (Second) of Contracts (1981)

¹⁹⁸² 363 F. 2d 312, at 315

of raw milk. On these facts the risk of a substantial or abnormal increase in the price of raw milk can be allocated to the plaintiff.” The court, nevertheless, stated that there could “conceivably” be a point “at which an increase in price of raw goods above the norm would be so disproportionate to the risk assumed as to amount to ‘impracticability’ in the commercial sense.”¹⁹⁸³

The legal consequence of the impracticability is that the obligor is discharged from performance. According to Section 269 of the Restatement (Second) of Contracts, temporary impracticability suspends the obligor's duty to perform, while the impracticability exists, but does not discharge his duty or prevent it from arising, unless his performance after the cessation of the impracticability would be materially more burdensome than had there been no impracticability. Section 272 (1) states that, in cases of impracticability, either party may have a claim for relief including restitution. Section 377 provides that “A party whose duty of performance ... is discharged as a result of impracticability of performance ... is entitled to restitution for any benefit that he has conferred on the other party by way of part performance or reliance.” Section 371 provides that if a sum of money is awarded as the measure of recovery, it may as justice requires be measured by either the market value of the performance or the “extent to which the other party’s property has been increased in value or his other interests advanced.” Section 377 qualifies this measure of recovery where a benefit is found to have conferred to a party by means of performance before the occurrence of the event, which later resulted in its destruction, and provides that “in that case recovery may be limited to the measure of increase in wealth prior to the event, if this is less than reasonable value.”¹⁹⁸⁴

Moreover, Section 272 (2) provides that “[i]n any case governed by the rules stated in this Chapter [dealing with impracticability of performance and frustration of purpose], if those rules together with the rules stated in Chapter 16 [Remedies] will not avoid injustice, the court may grant relief on such terms as justice requires including protection of the parties’ reliance interests.” Thus, the rule stated in Subsection (2) makes it clear that the court can “sever” the agreement and require that some unexecuted part of it be performed on both sides, rather than to relieve both parties of all of their duties, by supplying a term which is reasonable in the circumstances in order to avoid injustice.¹⁹⁸⁵ Moreover, Section 272 (2) allows the court to grant, instead of or in addition to restitution, the reliance interest when a contract is discharged for impracticability, in contrast to the traditional common law approach that, when there is no enforceable contract and no party is in breach, the only permitted action is that of restitution.¹⁹⁸⁶

b. International Instruments

The CISG addresses the issue of force majeure under Article 79, which provides that “A Party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.” This provision is considered as a compromise

¹⁹⁸³ 352 N.Y.S. 2d 784 (1974), at 790

¹⁹⁸⁴ Comment b on Section 377 of the Restatement (Second) of Contracts (1981)

¹⁹⁸⁵ Comment c on Section 272 of the Restatement (Second) of Contracts (1981)

¹⁹⁸⁶ Perillo Joseph M., Restitution in the Second Restatement of Contracts, Columbia Law Review, (January 1981), at 40

between the common law frustration or impracticability doctrine and the civil law force majeure doctrine. It was argued that, as these doctrines are quite distinct, and there are fundamental differences in values and assumptions, “the outcome of a dispute governed by this CISG provision may ultimately turn on whether a court chooses to emphasize the common law or civil law view”.¹⁹⁸⁷ The lack of reference to accepted doctrines and concepts of national laws, such as force majeure, impossibility, frustration and impracticability, renders the interpretation of Article 79 difficult, but this difficulty is a result of the general aims of the CISG to provide the autonomous and uniform application and to prevent the decision makers from resorting to their national laws to obtain guidance.¹⁹⁸⁸ However, it is pointed out that the requirements of supervening impediments under Article 79 echo in fact those of French doctrine of force majeure, which are characterized as exteriority, unforeseeability, and irresistibility.¹⁹⁸⁹

Article 79 of the CISG explicitly refers to “any obligation”, so that the buyer and the seller are subject to the same conditions.¹⁹⁹⁰ For an exemption to be granted, the non-performance of the contract must be due to an impediment, which was beyond the control of the party invoking the exemption. As the concept of fault has been set aside by the CISG, the fault of the defaulting party does not require consideration, but the exemption will not be granted if the defaulting party fails to behave as required under the contract, including the implicit obligation of good faith.¹⁹⁹¹ The impediment must also be reasonably unforeseeable at the time of the conclusion of the contract. If the event were foreseeable, the defaulting party should, in the absence of any contrary provision in the contract, be considered as having assumed the risk of its realization. In the determination of the foreseeability of the impediment, the CISG refers to the objective considerations, i.e. the reasonable person.¹⁹⁹² The use of “or” instead of “and” between the requirements of unforeseeability and unavailability in the text of Article 79 appears as reflecting the approach of the French case law that an unavoidable event, even if foreseeable, may constitute force majeure. However, it is usually argued that an unforeseeable impediment exempts the non-performing party only if he can prove that he has been reasonably unable “to have avoided or overcome [the impediment] or its consequences”.¹⁹⁹³ The basis of reference in the unavailability is the same

¹⁹⁸⁷ Note, Unification and Certainty: The United Nations Convention on Contracts for the International Sale of Goods, *Harvard Law Review*, 97(1984) at 1993

¹⁹⁸⁸ Tallon, Denis, Article 79 C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 573

¹⁹⁸⁹ Nicholas, Barry, Impracticability and Impossibility in the U.N. Convention on Contracts for the International Sale of Goods, in Nina M. Galston & Hans Smit (eds.), *International Sales: The United Nations Convention on Contracts for the International Sale of Goods*, Matthew Bender 1984, at 5-3

¹⁹⁹⁰ Tallon, Denis, Article 79 C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 575

¹⁹⁹¹ *Ibid.*, at 578-579

¹⁹⁹² *Ibid.*, at 580

¹⁹⁹³ It is stated in the Secretariat Commentary that “Even if the non-performing party can prove that he could not reasonably have been expected to take the impediment into account at the time of the conclusion of the contract, he must also prove that he could neither have avoided the impediment nor overcome it nor avoided or overcome the consequences of the impediment. This rule reflects the policy that a party who is under an obligation to act must do all in his power to carry out his obligation and may not await events which might later justify his non-performance. This rule also indicates that a party may be required to perform by providing what is in all the circumstances of the transaction a commercially reasonable substitute for the performance which was required under the contract.” Secretariat Commentary on Article 65 of the 1978 Draft [draft counterpart of CISG Art. 79]: Comment 7; available at: <http://www.cisg.law.pace.edu/cisg/text/secomm/secomm-79.html> Agreeing with this

as for unforeseeability, which is the reasonable person. Finally, the impediment must cause the non performance. The causality is to be denied, if the obligor is already in a situation of non-performance due to delay before the impediment arises, since that event would not have had any impact had performance been timely.¹⁹⁹⁴ Some argued that the impediment must be the exclusive cause of the non-performance.¹⁹⁹⁵ Alternatively, it is suggested that the impediment should also be accepted when a cause overtakes another cause and whether the impediment lastly has caused the breach of contract should be decisive.¹⁹⁹⁶

If the performance of the contract is only delayed by such an impediment, Article 79(3) provides that the exemption is temporary and has effect only for the period during which the event exists, thereby exempting the buyer from liability for damages for late performance. The provision, however, does not address the adverse consequences of the temporary event after its end for the parties.¹⁹⁹⁷ In the Vienna Conference, a proposal was made to add to paragraph (3) a provision that the non-performing party should be permanently exempted if at the end of the period of temporary exemption circumstances had “so radically changed that it would be manifestly unreasonable to hold him liable.”¹⁹⁹⁸ The proposal was rejected as a result of a reluctance to extend the provision to the cases of frustration or hardship.¹⁹⁹⁹ Nevertheless, it is argued that paragraph 3 can be interpreted to the effect that although the exemption has effect for the period during which the impediment exists, it may have permanent effect if after the impediment has ceased to exist the circumstances have so radically changed that it would be manifestly unreasonable to hold the non-performing party liable.²⁰⁰⁰

According to Article 79(4), the defaulting party must give notice to the other party of the impediment so as to enable the latter to take all the steps necessary to overcome the consequences of the failure. This rule can be considered as an instance of the application of

view see: Tallon, Denis, Article 79 C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 580 and Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 473 For a different opinion see: Kessedjian, Catherine, *Competing Approaches to Force Majeure and Hardship*, *International Review of Law and Economics*, 25 (September 2005), at 417 (“There are two cumulative conditions for the exemption to be possible. The first condition is that the party who claims exemption is faced with “an impediment beyond [its] control”. The second condition is that either the impediment could not have been reasonably foreseen at the time of the conclusion of the contract; or the party could not reasonably avoid or overcome the impediment or its consequences.”)

¹⁹⁹⁴ Arbitral Award, Bulgarian Chamber of Commerce and Industry, Case no 56/1995, 24 April 1996 (Coal case) [translation available at <http://cisgw3.law.pace.edu/cases/960424bu.html>]

¹⁹⁹⁵ Tallon, Denis, Article 79 C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 582

¹⁹⁹⁶ Enderlein, Fritz & Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary*, Oceana Publications, 1992, at 321

¹⁹⁹⁷ Kessedjian, Catherine, *Competing Approaches to Force Majeure and Hardship*, *International Review of Law and Economics*, 25 (September 2005), at 417

¹⁹⁹⁸ Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 104

¹⁹⁹⁹ Nicholas, Barry, *Impracticability and Impossibility in the U.N. Convention on Contracts for the International Sale of Goods*, in Nina M. Galston & Hans Smit (eds.), *International Sales: The United Nations Convention on Contracts for the International Sale of Goods*, Matthew Bender 1984, at 5-16

²⁰⁰⁰ Ibid.

the principle of good faith in general and the duty of cooperation in particular. The notice must reach the party to whom it is addressed within a reasonable time after the party in default “knew or ought to have known of the impediment”. If the notice has not been received within a reasonable time, the defaulting party is liable for damages, which result from the failure to give notice, but not the damages, which would follow from the non-performance of the contract.²⁰⁰¹

The legal consequence of the supervening impediment under Article 79 is that, the defaulting party is not liable for the failure to perform in the sense that the non-performance is acknowledged, but the party is exempted due to the impediment. However, paragraph 5 provides that “Nothing in this article prevents either party from exercising any right other than to claim damages under this Convention.” The language of the article seems to suggest that other than damages, all the other party's remedies are unaffected.²⁰⁰² Such other remedies include, the right to reduce price (Article 50), the right to compel performance (Articles 46 and 62), the right to avoid the contract (Articles 49 and 64) and the right to collect interest as separate from damages (Article 78). Among these remedies, it is generally argued that the right to compel performance is the most problematic under the CISG.²⁰⁰³ Apparently, the CISG would allow an action for specific performance in a case where the goods are destroyed or in the case where the transfer of funds is prohibited.²⁰⁰⁴ It should be noted that at the Vienna Conference, the proposal to extinguish the obligor's obligation to perform, if the grounds for exemption existed, was rejected due to the fear that a release from the obligation to perform could also extinguish collateral rights and secondary claims such as interest.²⁰⁰⁵ The general view expressed in the Vienna Conference was that judgment for a physically impossible performance would neither be sought nor obtained as a result of the legal doctrine “*impossibilium nulla est obligatio*”.²⁰⁰⁶ Thus, insofar as the impediment made performance actually impossible, there could be no specific enforcement, but it is argued that if performance was physically possible, but impracticable within the meaning of paragraph 1,

²⁰⁰¹ Tallon, Denis, Article 79 C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 586

²⁰⁰² Rimke, Joern, *Force majeure and Hardship: Application in International Trade Practice with specific regard to the CISG and the UNIDROIT Principles of International Commercial Contracts*, *Pace Review of the Convention on Contracts for the International Sale of Goods*, (1999-2000), at 218; Nicholas, Barry, *Impracticability and Impossibility in the U.N. Convention on Contracts for the International Sale of Goods*, in Nina M. Galston & Hans Smit (eds.), *International Sales: The United Nations Convention on Contracts for the International Sale of Goods*, Matthew Bender 1984, at 5-19 (“The remedies in question are, in case of non-performance by the seller, to avoid the contract, to compel performance or, in case of non-conformity, to reduce the price.”)

²⁰⁰³ Nicholas, Barry, *Impracticability and Impossibility in the U.N. Convention on Contracts for the International Sale of Goods*, in Nina M. Galston & Hans Smit (eds.), *International Sales: The United Nations Convention on Contracts for the International Sale of Goods*, Matthew Bender 1984, at 5-19

²⁰⁰⁴ Tallon, Denis, Article 79 C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 588

²⁰⁰⁵ Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 102

²⁰⁰⁶ Rimke, Joern, *Force majeure and Hardship: Application in International Trade Practice with specific regard to the CISG and the UNIDROIT Principles of International Commercial Contracts*, *Pace Review of the Convention on Contracts for the International Sale of Goods*, (1999-2000), at 218

the seller would not be liable in damages for not performing, yet can be compelled to perform.²⁰⁰⁷

However, it is pointed out that there is a danger that the national courts may set fines or penalties based on their rules of procedure for failure of the obligor to follow an order for specific performance (e.g. money penalties, such as *astreinte*), and, those fines or penalties could be the equivalent of granting damages and could even surpass them in amount.²⁰⁰⁸ Thus, it is argued that a national court should dismiss a complaint asking for specific performance in such a case, on the basis of Article 28, which declares that the courts are not bound to order specific performance if they would not do so according to their national laws.²⁰⁰⁹ Alternatively, it is suggested that Article 79 (5) should be construed in light of the UNIDROIT Principles, without recourse to domestic law.²⁰¹⁰ Article 7.2.2 of the UNIDROIT Principles adopts the principle of specific performance subject to qualifications. It prevents the order of specific performance when the performance is impossible in law or in fact, unreasonably burdensome or expensive, or when the party entitled to performance may reasonably obtain performance from another source.

The exemption under Article 79 does not preclude the right to avoid the contract in accordance with Article 25, which requires a fundamental non-performance, since the character of a conduct being a non-performance is not affected by the existence of impediments.²⁰¹¹ As Article 26 requires that a declaration of avoidance of the contract is effective only if made by notice to the other party, *ipso facto* avoidance is excluded.²⁰¹² However, the right to avoid the contract remains limited to the party against which the non-performance is committed, and a proposal to introduce such a right also for the other party did not meet with a favorable response.²⁰¹³ If that party avoids the contract, the normal consequences of avoidance become applicable subject to the exclusion of damages as an available remedy to the obligee. Article 81 (1) releases both parties from their obligations under the contract. According to Article 81 (2), a party who has performed the contract either wholly or in part may claim restitution from the other party of whatever the first party has supplied or paid under the contract. Moreover, pursuant to Article 84, the seller, who is bound to refund the price, must also pay interest on it, and the buyer must account to the seller for all benefits which he has derived from the goods if he must make restitution of the goods, or if it

²⁰⁰⁷ Nicholas, Barry, *Impracticability and Impossibility in the U.N. Convention on Contracts for the International Sale of Goods*, in Nina M. Galston & Hans Smit (eds.), *International Sales: The United Nations Convention on Contracts for the International Sale of Goods*, Matthew Bender 1984, at 5-19

²⁰⁰⁸ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 493

²⁰⁰⁹ Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 102

²⁰¹⁰ Brunner, Christoph, *Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration*, Kluwer Law International, 2009, at 364

²⁰¹¹ Enderlein, Fritz & Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary*, Oceana Publications, 1992, at 331

²⁰¹² Will, Michael, Article 49, C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 361

²⁰¹³ Enderlein, Fritz & Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary*, Oceana Publications, 1992, at 331

is impossible for him to make restitution of the goods or to make restitution of the goods substantially in the condition in which he received them.

The approach of the CISG to the force majeure issues has been influential on the regulation of those issues in the international restatements of contract principles. Both the UNIDROIT Principles and the PECL deal with the issues of force majeure in their respective chapters on non-performance, and follow the approach of the CISG, which adopts a unitary concept of non-performance. Thus, even if the failure to perform is excused by force majeure, it is still treated as “non-performance”. However, in such cases, the available remedies are restricted: the aggrieved party may not claim specific performance or damages, but he may terminate the contract, withhold performance, reduce the price or claim interest on money due.²⁰¹⁴

Article 7.1.7 (1) of the UNIDROIT Principles was taken almost literally from Article 79 (1) of the CISG.²⁰¹⁵ It excludes a party’s liability for non-performance if he proves that the non-performance was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences. In the Official Comments, it is stated that Article 7.1.7 “covers the ground covered in common law systems by the doctrines of frustration and impossibility of performance and in civil law systems by doctrines such as force majeure, Unmöglichkeit, etc. but it is identical with none of these doctrines.” It is also explained that the reason for the choice of the title “force majeure” is that the term is widely known in international trade practice, as confirmed by the inclusion of “force majeure” clauses.²⁰¹⁶ Article 7.1.7 of the UNIDROIT Principles is a default rule applicable insofar as the parties have not themselves allocated risks in their contract. The parties may either broaden or to narrow the excuses provided by the default rule. The freedom of limiting the obligor’s liability through allocation of risks, such as exemption clauses or, more specifically, force majeure clauses, is limited by the prohibition of clauses whose application would lead to a grossly unfair result, as provided in Article 7.1.6 on the exemption clauses.²⁰¹⁷

Similar to the Article 79 (1) of the CISG, Article 7.1.7 (1) of the UNIDROIT Principles reflects the requirements of French doctrine of force majeure, where the event must be exterior, unforeseeable and irresistible to relieve liability. Article 7.1.7(1) firstly requires that the obligor must prove that its non-performance was caused by an impediment beyond its control. Thus, the event which causes non-performance must be external to the obligor’s ‘sphere of risk’.²⁰¹⁸ Secondly, the impediment must be unforeseeable in the sense that the obligor could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract. Thirdly, the impediment must be irresistible in the sense that the obligor could not reasonably have expected to have avoided or overcome the event, or rather its consequences, which eventually caused performance to fail, as if he was under a duty of best efforts. In determining the limits of reasonable conduct to avoid or

²⁰¹⁴ Brunner, Christoph, *Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration*, Kluwer Law International, 2009, at 58

²⁰¹⁵ Bonell, Michael Joachim, *An International Restatement of Contract Law: the UNIDROIT Principles of International Commercial Contracts*, Transnational Publishers, 3rd ed., 2005, at 148

²⁰¹⁶ Official Comment 1 to Article 7.1.7 of the UNIDROIT Principles

²⁰¹⁷ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 768

²⁰¹⁸ *Ibid.*, at 771

overcome the impediment, the threshold should be set at least as high as that of hardship, which requires a fundamental alteration of the equilibrium of the contract, pursuant to Article 6.2.2 of the UNIDROIT Principles.

Article 7.1.7 (2) of the UNIDROIT Principles provides that when the impediment is only temporary, the excuse shall have effect for such period as is reasonable having regard to the effect of the impediment on the performance of the contract. Thus, the obligor's exemption may continue for some time after the original impediment has ceased because the focus is on the effect of the impediment on the progress of the contract and the period of time during which the performance is effectively delayed. This allows taking into account the effect of consequential impediments caused by the original event, as opposed to the corresponding provision of the CISG, which the Working Group considered inappropriate for the contracts other than sale.²⁰¹⁹ According to Article 7.1.7 (3) of the UNIDROIT Principles, the party who fails to perform must give notice to the other party of the impediment and its effect on its ability to perform. The notice of impediment must be received by the obligee "within a reasonable time after the party who fails to perform knew or ought to have known of the impediment". Delay in giving effective notice does not deprive the obligor of the right to invoke force majeure, but leads to his liability for damages caused to the obligee by the delay.

In the cases of force majeure under the UNIDROIT Principles, there is a non-performance, but the remedies that are available to the aggrieved party are subject to limitations.²⁰²⁰ The excused non-performance does not give rise to the right to damages under Article 7.4.1 and the claim for specific performance is precluded due to the qualifications of Article 7.2.2. According to Article 7.1.7 (4), either party may exercise a right to terminate the contract or to withhold performance or request interest on money due. The Official Comment explains that the article does not restrict the rights of the party, who has not received performance, to terminate the contract if the non-performance is fundamental under the conditions of Article 7.3.1.²⁰²¹ In case of a temporary impediment of performance, the parties may only terminate the contract if the resulting delay in performance amounts to a fundamental non-performance. The right to terminate is to be exercised by giving notice to the other party according to Article 7.3.2. Thus, under the UNIDROIT Principles, the impediment does not automatically terminate a contract.²⁰²²

In cases of force majeure if a party exercises its right to terminate the contract under the conditions of Article 7.3.1, the normal consequences of termination under Articles 7.3.5-7.3.7 will be applicable to both parties. According to Article 7.3.5, termination of the contract releases both parties from their obligation to effect and to receive future performance. Article 7.3.6 (1) provides that, on termination of a contract to be performed at one time, either party

²⁰¹⁹ UNIDROIT 1990 – Study L – Doc. 45, Rome, April 1990, at 5-6; Also see illustration 2 in the Official Comments to Article 7.1.7 of the UNIDROIT Principles

²⁰²⁰ By contrast, an obligor's non-performance is not excused where it is caused by the interference of the other party (Article 7.1.2), or where it is withheld due to the other party's failure to tender its performance (Article 7.1.3). In these cases, the obligor's failure or refusal to perform does not qualify as non-performance in the first place and, the other party is not able to invoke non-performance and may not avail itself of any of the remedies under Chapter 7 of the UNIDROIT Principles. Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 733

²⁰²¹ Official Comment 2 to Article 7.1.7 of the UNIDROIT Principles

²⁰²² Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 841

may claim restitution of whatever it has supplied under the contract, provided that such party concurrently makes restitution of whatever it has received under the contract. The Official Comments are not clear in relation to the application of this provision to force majeure cases. In force majeure cases, given that the obligee will not receive the performance of the obligor due to the supervening event, its right to claim restitution should depend solely on its restitution of anything it has received from the obligor under the contract other than the performance of the extinguished obligation and, in the likely case where the obligee has not received anything under the contract, it should nevertheless be able to claim restitution of whatever it has supplied under the contract. Pursuant to Article 7.3.7 (1), on termination of a contract to be performed over a period of time, restitution can only be claimed for the period after termination has taken effect, provided the contract is divisible. In both cases, if restitution in kind is not possible or appropriate, an allowance has to be made in money whenever reasonable if, and to the extent that, the performance has conferred a benefit on its recipient.²⁰²³ Moreover, Article 7.3.6 (4), which is applicable to both contracts to be performed at one time and contracts to be performed over a period of time, allows the parties to claim compensation for expenses reasonably required to preserve or maintain the performance received. During the drafting process, some members of the Working Group considered the Article 7.3.6 (4) as being relevant to the force majeure cases where there is no right to damages for non-performance.²⁰²⁴ Finally, the UNIDROIT Principles do not take a position concerning benefits that have been derived from the performance, or interest that has been earned. The issue of interest can be resolved by means of Article 7.4.9 which provides that if a party does not pay a sum of money when it falls due, the aggrieved party is entitled to interest. With regard to the other types of benefits, the Official Comments merely state that in commercial practice it will often be difficult to establish the value of the benefits received by the parties as a result of the performance, and often both parties will have received such benefits.²⁰²⁵ However, in cases of force majeure, the obligor will not be able to perform its obligations and confer benefits on the obligee, and it is unclear whether the benefits may be claimed by the obligee, who has performed its obligation and demands restitution of its performance under the UNIDROIT Principles.

The PECL regulate the issue in Article 8:108, but do not use the expression “force majeure”. The provision is titled “excuse due to an impediment”. The conditions under which the provision operates are very similar to the CISG and the UNIDROIT Principles. Article 8:108 (1) provides that a party's non-performance is excused if he proves that it is due to an impediment beyond his control and that he could not reasonably have been expected to take the impediment into account at the time of the conclusion of the contract, or to have avoided or overcome the impediment or its consequences. The Official Comment defines the scope of application by stating that “unlike the equivalent article of CISG [...] Article 8:108 has to apply only in cases where an impediment prevents performance”, and states that the conditions of the impediment are those “traditionally required for force majeure.”²⁰²⁶ Similar to the French doctrine of force majeure, these conditions are stated as the three features of a particular event, i.e. exteriority, unforeseeability, unavailability. First, the event must be something outside the obligor's sphere of control and it must have come about without the

²⁰²³ Official Comment 3 to Article 7.3.6 of the UNIDROIT Principles

²⁰²⁴ UNIDROIT 2008 - Study L - Misc.28, October 2008, at 10

²⁰²⁵ Official Comment 6 to Article 7.3.6 of the UNIDROIT Principles

²⁰²⁶ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 378

fault of either party. Secondly, the event could not have been taken into account at the time the contract was made, since, otherwise, one may say either that the party affected took the risk or that it was at fault in not having foreseen it. In this condition, the test is “reasonable” foreseeability, focusing on whether a normal person, placed in the same situation, could have foreseen it without either undue optimism or undue pessimism.²⁰²⁷ Finally, the impediment must be insurmountable or irresistible, and reasonableness also qualifies this condition. The Official Comments explain that “both conditions - that the party could not have avoided it and could not have overcome it - must be fulfilled before an excuse can operate” and “the party to be excused must prove that it could not have done either.”²⁰²⁸

In Article 8:108 (2) of the PECL, it is provided that where the impediment is only temporary, the excuse has effect for the period during which the impediment exists. It is also stated in the same paragraph that, if the delay amounts to a fundamental non-performance, the obligee may treat it as such. In the Official Comments, it is acknowledged that the consequences of the impediment may last longer than the event itself, so the term “temporary impediment” means not only the event which causes the obstacle but also its consequences.²⁰²⁹ Article 8:108 (3) of the PECL requires the non-performing party to give notice of the impediment and of its effect on its ability to perform, which should be received by the other party within a reasonable time after the non-performing party knew or ought to have known of these circumstances. In case of failure to give notice, the other party is entitled to damages for any loss resulting from the non-receipt of such notice. In the Official Comments, it is stated that, depending on the circumstances of the case, the “reasonable time” condition may even require immediate notification.²⁰³⁰

As to the legal consequences of the force majeure, the Article 8:108 does not contain an explicit provision. In the Official Comments, it is stated that an impediment to performance relieves the party which has not performed from liability, and the decision maker should adopt a pragmatic approach to the availability of various remedies. It is stated that any form of specific performance is by definition impossible, and any form of damages, including liquidated damages and penalties, does not apply unless the parties have agreed otherwise. With regard to termination, the PECL retain the same general system that applies in the case of non-performance of contract. Pursuant to Article 9:305, both parties are released from their obligation to effect and to receive future performance. The restitution of money and property supplied under the contract is governed by Articles 9:307 and 9:308, both of which require the lack of counter-performance for a claim of restitution.²⁰³¹ Article 9:308 does not cover the issue of benefits derived from performance in the context of restitution of property. Article 9:309 provides that, on termination of the contract a party who has rendered a performance which cannot be returned and for which it has not received payment or other counter-performance may recover a reasonable amount for the value of the performance to the other party. In the Official Comments, it is explained that although the obligor is not liable in

²⁰²⁷ Ibid., at 379

²⁰²⁸ Ibid., at 380

²⁰²⁹ Ibid., at 381

²⁰³⁰ Ibid., at 382

²⁰³¹ Article 9:307: Recovery of Money Paid: “On termination of the contract a party may recover money paid for a performance which it did not receive or which it properly rejected.”; Article 9:308: Recovery of Property: “On termination of the contract a party who has supplied property which can be returned and for which it has not received payment or other counter-performance may recover the property.”

damages because its non-performance was excused under Article 8:108, the obligee may recover the benefit, which has been received by the obligor as a result of the obligee's performance, and for which the obligee has not received payment or other counter-performance, but the party which has received the benefit should not be required to pay the cost to the other of having provided it, if the net benefit to it is less, since it is only enriched by the latter amount.²⁰³²

Article 9:303 (4) provides an exception to the rule that notice of termination must be given, as it is considered to be pointless to give the aggrieved party the right to keep in force a contract which has become totally and permanently impossible to perform. Thus, the PECL adopted the approach in those legal systems under which force majeure brings automatic termination of the contract.²⁰³³ It is further stated that, in the case of a partial impediment, i.e. when a divisible part of the main obligation or a secondary obligation becomes impossible, the creditor has a choice between terminating the contract and demanding performance of unaffected part of the contract. In the latter case, the creditor's obligation will be reduced proportionately under Article 9:401 (Reduction of Price).²⁰³⁴

c. Contracting Practices

In the international contracting practice, there is a variety of approaches in relation to both the concept of force majeure and its legal consequences, since they are generally regulated by default rules under the national legal systems. In 1985, the ICC drew up a document containing "drafting suggestions" with various alternatives in relation to force majeure and hardship clauses, in order to facilitate the discussions of contract drafters. The document also contained a model "Force majeure (exemption) clause".²⁰³⁵ These suggestions and the model clause were updated in 2003.²⁰³⁶ The ICC Model Force Majeure Clause of 1985 or 2003 can be incorporated by parties who may find it easier to do so than to negotiate clauses on their own. The ICC Model International Franchising Contract (2000) and the ICC Model International Sales Contract (1997) contain a Force Majeure clause, largely inspired by the ICC Force Majeure Clause of 1985, while the Force Majeure clause of the ICC Model Contract for the Turnkey Supply of an Industrial Plant is based on the ICC Force Majeure Clause of 2003.²⁰³⁷ The ICC Model Mergers and Acquisitions Contract (2004) provides a reference to ICC Force Majeure Clause of 2003.²⁰³⁸ Surprisingly, the ICC Model Commercial

²⁰³² Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 424-425; This is similar to the approach in Comment b on Section 377 of the Restatement (Second) of Contracts, which qualifies the general measure of market value in cases of impracticability, and limits the amount of recovery to the increase in wealth prior to the event if this is less than market value, even though the event later resulted in its destruction.

²⁰³³ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 380

²⁰³⁴ *Ibid.*, at 381

²⁰³⁵ ICC, *Force Majeure and Hardship*, ICC Publication No. 421, Paris, 1985

²⁰³⁶ ICC Force Majeure Clause 2003, ICC Hardship Clause 2003, ICC Publication No. 650

²⁰³⁷ ICC Model International Sale Contract, General Conditions, Article 13, ICC Publication No. 556, 1997; ICC Model International Franchising Contract, Article 26 with reference to Schedule 13, ICC Publication No. 557, 2000; ICC Model Contract for the Turnkey Supply of an Industrial Plant, Article 33, ICC Publication No. 653, 2003

²⁰³⁸ Article 15.8 of the ICC Model Mergers & Acquisitions Contract 1 - Share Purchase Agreement, ICC Commission on Commercial Law & Practice ICC Publication No. 656, 2004

Agency Contract (2002) does not contain a force majeure clause or a reference to the ICC Force Majeure Clauses, despite the long term of the contractual relationship.²⁰³⁹ The general approach of the CISG and the international restatement of contract principles to the issues of force majeure seems to have influenced the ICC Force Majeure Clauses of 1985 and 2003. However, there is not sufficient evidence as to the extent of use of these ICC Force Majeure Clauses of 1985 or 2003 in commercial transactions and, instead, a wide variety of force majeure clauses can be observed in the international contracting practices.

The force majeure clauses in international contracting practices usually include the definition of the events constituting force majeure. The contractual definitions of force majeure sometimes highlight the traditional criteria, which can be found in French doctrine, the CISG and international restatements of contract principles, namely, exteriority, unforeseeability and unavailability.²⁰⁴⁰ A similar approach was adopted by the ICC Force Majeure Clause 1985, and its first paragraph provided that “A party is not liable for a failure to perform any of his obligations in so far as he proves; - that the failure was due to an impediment beyond his control; and - that he could not reasonably be expected to have taken the impediment and its effects upon his ability to perform into account at the time of the conclusion of the contract; and - that he could not reasonably have avoided or overcome it or at least its effects.”²⁰⁴¹

The earlier editions of the FIDIC Conditions of Contract for Construction (the Red Book) contained no force majeure clause, and the contractor had, under the old Red Book, some of the relief typically provided by a force majeure clause due to a combination of Clause 44, dealing with extensions of time and Clause 65, dealing with Special Risks, including war.²⁰⁴² A force majeure clause, Clause 19, was introduced into all of the new editions of FIDIC Conditions for major works in 1999.²⁰⁴³ Clause 19 defines “Force Majeure” as “an exceptional event or circumstance: (a) which is beyond a Party’s control, (b) which such Party could not reasonably have provided against before entering into the Contract, (c) which, having arisen, such Party could not reasonably have avoided or overcome, and (d) which is not substantially attributable to the other Party.”

In international contracting practices, there are also force majeure clauses, which omit one or another of the criteria of force majeure in the definition and provide more flexibility in its application. For example, unforeseeability or unavailability is not expressly required in some clauses, or those requirements are relaxed by reference to “reasonableness” or “due diligence” in the efforts of the obligor to foresee or avoid an impediment. The expression “beyond the control of the parties” is commonly used to assess force majeure, but it is also relaxed in some clauses by reference to “reasonableness”, such as “an impediment beyond [obligor’s] reasonable control” in ICC Force Majeure Clause of 2003.²⁰⁴⁴ Similarly, although there is

²⁰³⁹ Van Houtte, Hans, ICC Model Contracts, *International Business Law Journal*, (2003), at 263

²⁰⁴⁰ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 403

²⁰⁴¹ ICC, Force Majeure and Hardship, ICC Publication No. 421, Paris, 1985

²⁰⁴² Both the old Yellow Book: Conditions of Contract for Electrical and Mechanical Works, Third Edition, 1987 (Clause 44) and the Orange Book: Conditions of Contract for Design-Build and Turnkey, First Edition 1995 (Clause 19) contained a force majeure clause. Seppälä, Christopher R., FIDIC's New Standard Forms of Contract – Risks, Force Majeure, Claims and Termination, *International Business Law Journal*, (2000), at 1019-1020

²⁰⁴³ Conditions of Contract for Construction (new Red Book), Conditions of Contract for Plant and Design Build (new Orange/Yellow Book), Conditions of Contract for EPC/Turnkey Projects (Silver Book)

²⁰⁴⁴ ICC Force Majeure Clause 2003, ICC Hardship Clause 2003, ICC Publication No. 650

usually a reference to the effect of force majeure events on the performance of the contract, it is not always required that performance be absolutely impossible, such as the performance becoming “impossible or exorbitant from an industrial or commercial standpoint”.²⁰⁴⁵ There are also clauses, which do not contain a definition or any criterion for the determination of a force majeure event, but just providing a list of examples, which can give an indication to the decision maker interpreting the contract.²⁰⁴⁶ In practice, the force majeure clauses commonly include a list of supervening events. The most frequently cited examples are: natural disasters or acts of God; armed conflicts; strikes, lockouts or other industrial disputes either inside or outside the enterprise of the obligor; breakdown of machinery and similar accidents; transport or procurement difficulties; intervention of public authorities (*fait du prince*) or change of legislation.²⁰⁴⁷ In most of the cases, the list of examples are not exhaustive and introduced by an expression, such as “in particular” or “for example”, or followed by an expression, such as “or other similar circumstances”.

The ICC Force Majeure Clause of 1985 also reflects the practice of listing specific events and provides that the list is not exhaustive.²⁰⁴⁸ Instead of declaring that the list of events is not exhaustive, the ICC Force Majeure Clause of 2003 attempts to clarify the relationship between the definition of force majeure and the list of specific events, by providing that the specific events listed shall be presumed to have established the conditions described in the definition in the absence of proof to the contrary and unless otherwise agreed in the contract between the parties expressly or impliedly, except for the condition of unavailability. In the comments, it is explained that the list of force majeure events establishes evidential advantages for a party invoking the clause, but even when invoking a listed event, that party still needs to prove that it could not reasonably have avoided or overcome the effects of the listed event.²⁰⁴⁹ The list provided by Clause 19 of the FIDIC Conditions mainly consists of events of war and related risks, and natural disasters. The list is not exhaustive and, it is provided that a specific event from the list can only be invoked if it satisfies the conditions stipulated in the definition of force majeure.

Usually, there are attempts at contractual characterization of a contingency that diverges from the criteria traditionally employed by the national legal systems, by including in the lists such events that otherwise would not be categorized as force majeure, as a form of risk allocation.²⁰⁵⁰ The parties sometimes list events which will not constitute force majeure, even if they do meet the conditions for force majeure under the definition of force majeure clause or under the applicable national law. The ICC Force Majeure Clause of 1985 also provides a list of events, which do not constitute force majeure, namely “lack of authorizations, of licenses, of entry or residence permits, or of approvals necessary for the performance of the contract and to be issued by a public authority of any kind whatsoever in the country of the party seeking relief.”

²⁰⁴⁵ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 403-405

²⁰⁴⁶ *Ibid.*, at 408

²⁰⁴⁷ *Ibid.*, at 408-413

²⁰⁴⁸ ICC, *Force Majeure and Hardship*, ICC Publication No. 421, Paris, 1985

²⁰⁴⁹ ICC Force Majeure Clause 2003, ICC Hardship Clause 2003, ICC Publication No. 650

²⁰⁵⁰ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 401

The force majeure clauses in international contracts usually require the party invoking the clause to notify the other contracting party of force majeure event and, if it is temporary, of its cessation. Many force majeure clauses provide the requirement that notice be given “as soon as possible” or immediately, and some even specify time limits in the form of a certain number of days. The ICC Force Majeure Clause of 1985 requires the party seeking relief to give notice to the other party of such impediment and its effects on his ability to perform, as soon as practicable after the impediment and its effects upon his ability to perform became known to him, and to notify the other party when the ground of relief ceases. The ICC Force Majeure Clause of 2003 requires the party invoking the clause to give notice without delay from the time at which the impediment causes the failure to perform. Clause 19 of the FIDIC Conditions provides that the party, who is or will be prevented from performing its substantial obligations under the contract by force majeure, shall give notice to the other party of the event or circumstances constituting the force majeure and shall specify the obligations, the performance of which is or will be prevented. Clause 19 specifies the time limit for the notice as within 14 days after the party became aware, or should have become aware, of the relevant event or circumstance constituting force majeure.

The consequences of the failure to give notice are also usually stated in the force majeure clauses. In the ICC Force Majeure Clause of 1985, the failure to notify mainly affects the extent of relief provided due to the force majeure event since, if notice is not timely given, the ground of relief takes effect, not from the time of the impediment, but from the time of notice and, in addition to that, the failing party becomes liable in damages for loss which otherwise could have been avoided.²⁰⁵¹ Similarly, in the ICC Force Majeure Clause of 2003, if notice is not given without delay, the relief from the duty to perform starts from the time at which notice reaches the other party, and not from the time at which the impediment causes the failure to perform. Clause 19 of the FIDIC Conditions requires notification as a condition for the right to claim force majeure, and the party failing to give notice has no right to claim force majeure within the meaning of Clause 19.²⁰⁵²

The legal consequences of force majeure events are often regulated in the contractual clauses. In force majeure clauses, the occurrence of force majeure events will, at least temporarily, exempt the liability of the obligor from non-performance of certain obligations arising from the contract. While some clauses do not even mention explicitly this consequence as it is considered self-evident, other clauses emphasize this aspect.²⁰⁵³ The ICC Force Majeure Clause of 1985 states explicitly that “A party is not liable for a failure to perform in so far as he proves” that the conditions of force majeure exemption have been established. In the comments, it is stated that the failing party is relieved not only from damages but also from penalties and other contractual sanctions, but the party is not relieved from paying interest on

²⁰⁵¹ Comment No. 11 to the ICC Force Majeure Clause of 1985 states that “Failure to give such notice in time would not only make the failing party liable in damages (Paragraph 5), but also deprive him of the right to rely on the exemption clause in respect of time before the notice. The latter is a rather harsh and serious consequence. In some contractual relations it may be difficult for the obligor to realise at once whether he will need to rely on the exemption clause. Parties who feel that such a limitation of the exemption clause is unreasonable may strike out the first sentence of Paragraph 5 (“The ground... of notice”).” ICC, Force Majeure and Hardship, ICC Publication No. 421, Paris, 1985, at 15

²⁰⁵² Seppälä, Christopher R., FIDIC's New Standard Forms of Contract – Risks, Force Majeure, Claims and Termination, *International Business Law Journal*, (2000), at 1021

²⁰⁵³ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 424

a sum due.²⁰⁵⁴ The ICC Force Majeure Clause of 2003 provides that “A party successfully invoking this Clause is, ..., relieved from its duty to perform its obligations under the contract” and “from any liability in damages or any other contractual remedy for breach of contract”.

Sub-Clause 19.2 of the FIDIC Conditions provides that “the Party shall, having given notice, be excused performance of its obligations for so long as such Force Majeure prevents it from performing them.” Sub-Clause 19.2 provides that “Notwithstanding any other provision of this Clause, Force Majeure shall not apply to obligations of either Party to make payments to the other Party under the Contract.” Usually, the force majeure clauses in the international contracting practice do not specify this aspect due to the rule *genera non pereunt*, according to which the payment of a sum of money is never rendered impossible by the occurrence of force majeure.²⁰⁵⁵ In the comments to ICC Force Majeure Clause of 1985, it is stated that the clause covers non-performance of all kinds of obligations, including even monetary ones, but, in the case of payment, the duty to overcome the impediment is a very absolute one, and the conditions for relief will be satisfied only in exceptional circumstances.²⁰⁵⁶

In the practice of international contracts, the initial effect of force majeure is usually the suspension of the performance of the contract. Particularly in the context of long-term contractual relationship, the parties take into account and emphasize the possibility of temporary nature of the event in the force majeure clauses. Most of the force majeure clauses extend the time limits for performance equal to the time during which performance is suspended. However, there are also clauses, which suspend performance, but do not prolong the duration of the contract, thereby cancelling a certain part of performance in some cases.²⁰⁵⁷

The major consequence of the suspending effect of force majeure is that the parties are prevented from terminating the contract during the period of suspension. The ICC Force Majeure Clause of 1985 makes this aspect clear by providing that force majeure “postpones the time for performance, for such period as may be reasonable, thereby excluding the other party's right, if any, to terminate or rescind the contract.” In determining the reasonable period, the ICC Clause 1985 requires the decision maker to take into account the failing party's ability to resume performance, and the other party's interest in receiving performance despite the delay. Similarly, the ICC Force Majeure Clause of 2003 emphasizes the temporary nature of force majeure in suspending performance and precluding termination. Sub-Clause 19.4 of the FIDIC Conditions also provides for the extension of time limits resulting from the suspension of the obligations of the contract. It provides that if the contractor is prevented from performing its substantial obligations and suffers delay by reason of force majeure, the contractor shall be entitled to an extension of time for any such delay. Moreover, Sub-Clause 19.4 mentions the costs resulting from the suspension for the contractor, including the costs of rectifying or replacing the works and/or goods damaged or destructed by force majeure, as a matter of risk allocation between the parties. It provides that if the contractor incurs costs by reason of force majeure, the contractor shall be entitled to payment of any cost in the case of

²⁰⁵⁴ ICC, Force Majeure and Hardship, ICC Publication No. 421, Paris, 1985, at 15

²⁰⁵⁵ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 436

²⁰⁵⁶ ICC, Force Majeure and Hardship, ICC Publication No. 421, Paris, 1985, at 15-16

²⁰⁵⁷ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 425

war and related risks, which are assumed by the employer, and listed in sub-paragraphs (i) to (iv) of Sub-Clause 19.1 as force majeure events, to the extent they are not indemnified through the insurance policy, while the contractor assumes the risk of natural catastrophes, such as earthquake, hurricane, typhoon or volcanic activity, which are listed as force majeure events under Sub-Clause 19.1 (v), insofar as the costs incurred by the contractor by reason of such force majeure events will not be recoverable from the employer.

The emphasis on the suspending effect of force majeure usually leads the drafters of force majeure clauses to oblige the party invoking the clause to overcome the impediment or both parties to cooperate in overcoming the impediment, in a way to re-establish the conditions enabling performance of the contract to be resumed. This obligation of cooperation is often formulated in a form of duty of “best efforts” or its variants and the failure to perform this duty results in payment of damages. This duty is not explicitly provided in the ICC Force Majeure Clause of 1985, but, in its comments, it is stated that “A party in breach should try to minimise damages caused by a failure to perform, both in his own interests and in those of the other party. If he does not do so he may be liable to pay compensation for loss or damage which otherwise could have been avoided, even though in principle the exemption clause operates.” The ICC Force Majeure Clause of 2003 explicitly provides that “A party invoking this Clause is under an obligation to take all reasonable means to limit the effect of the impediment or event invoked upon performance of its contractual duties.” Sub-Clause 19.3 of the FIDIC Conditions places this duty on both parties, and provides that “Each Party shall at all times use all reasonable endeavours to minimise any delay in the performance of the Contract as a result of Force Majeure.”

As the suspension of the obligations resulting from force majeure cannot be prolonged indefinitely, most of the force majeure clauses in international contracting practice provide that, after a certain time limit, if the force majeure event has not ended, the contract may be terminated. In some clauses, it is provided that the parties will renegotiate if the suspension due to force majeure goes on beyond a fixed time limit. If renegotiations fail, force majeure clauses varyingly provides for termination or intervention of the arbitrators.²⁰⁵⁸ However, in general practice, the most common consequence of a prolonged force majeure event is that the obligee may terminate the contract.²⁰⁵⁹

Some contracts confer a right to terminate on each of the parties, and those clauses usually provides for a requirement of notice termination. The ICC Force Majeure Clauses of 1985 and 2003 adopt this approach. ICC Force Majeure Clause of 1985 provides that if the grounds of relief subsist for more than such period as the parties provide, or in the absence of such provision for longer than a reasonable period, either party shall be entitled to terminate the contract with notice. ICC Force Majeure Clause of 2003 grants the right to terminate to either party by notification within a reasonable period to the other party, provided that the duration of the impediment has the effect of substantially depriving either or both of the contracting parties of what they were reasonably entitled to expect under the contract. Sub-Clause 19.6 of the FIDIC Conditions specifies a period of time after which the contract may be terminated. If the execution of substantially all the works in progress is prevented for a continuous period of 84 days, or for multiple periods which total more than 140 days, then either party may give to the other party a notice of termination of the contract, upon which the termination shall take effect 7 days after the notice is given. However, Sub-Clause 19.7 of the FIDIC Conditions

²⁰⁵⁸ Ibid., at 432-433

²⁰⁵⁹ Ibid., at 430

does not require any initial period of suspension or any notice of termination, if any event or circumstance outside the control of the parties arises, which makes it impossible or unlawful for either or both parties to fulfill its or their contractual obligations or which, under the law governing the contract, entitles the parties to be released from further performance of the contract. In those cases, upon notice by either party to the other party of such event or circumstance, the parties are released from further performance of the contract, implying that the contract comes to an end automatically, and the contractor is paid the same amount as he would be paid if the contract were terminated under Sub-Clause 19.6.

When the contract is terminated due to force majeure, there is the problem of winding up the contractual relationship. Many force majeure clauses contain no specific provisions in this regard.²⁰⁶⁰ The ICC Force Majeure Clauses of 1985 prefers to cover the problem of winding up by general terms of restitution. It provides that “Each party may retain what he has received from the performance of the contract carried out prior to the termination. Each party must account to the other for any unjust enrichment resulting from such performance. The payment of the final balance shall be made without delay.” The ICC Force Majeure Clause of 2003 and Sub-Clause 19.6 of the FIDIC Conditions tend to limit or exclude restitution and provide, instead, for monetary adjustments. The ICC Force Majeure Clause of 2003 states that when the contract is terminated and either party has, by reason of anything done by another party in the performance of the contract, derived a benefit before the termination of the contract, the party deriving such a benefit shall be under a duty to pay to the other party a sum of money equivalent to the value of such benefit. Sub-Clause 19.6 of the FIDIC Conditions provides that upon termination, the engineer shall determine the value of the work done and issue a payment certificate and the contractor will be paid accordingly. The payment certificate shall include the amounts payable for any work carried out for which a price is stated in the contract and certain costs incurred by the contractor, such as the cost of plant and materials ordered for the works and delivered to the contractor, which shall become the property of (and be at the risk of) the employer when paid for by the employer, other costs or liabilities which in the circumstances were reasonably and necessarily incurred by the contractor in the expectation of completing the works, the cost of removal of temporary works and contractor’s equipment from the site and the return of these items to the contractor’s works in his country, and the cost of repatriation of the contractor’s staff and labor employed wholly in connection with the works at the date of termination.

2. Arbitral Decision Making

It is argued that the theory of *lex mercatoria* was initially formulated around the concept of force majeure, because the national legal systems in dealing with force majeure issues were traditionally confronted with discrete and short term contracts, such as sales contracts, where the performance of both parties occurred immediately or over a relatively short period, and the international merchants have developed private solutions, better articulated than those offered by national legal systems.²⁰⁶¹ However, the national legal system also evolves to meet the changes in the relevant society in which it aims to establish an order. It can be observed that there is an increasing tendency in the national legal systems with regard the issues of force majeure to emphasize an approach that focuses on risk allocations between the parties

²⁰⁶⁰ Ibid., at 434

²⁰⁶¹ Draetta, Ugo, Force Majeure Clauses in International Trade Practice, *International Business Law Journal*, (1996), at 547

and the use of standards that enable the decision makers to exercise their power of discretion in order to adapt the law to the circumstances of the particular case.

Essentially, in view of the highly divergent understanding of the concepts of force majeure, impossibility, frustration, impracticability or supervening impediments across the different categories of the sources of abstraction, the national law that is found to be governing the substance of the dispute by the application of *lex mercatoria* at the conflict of laws stage should become the major determinant of reasonable expectations, in the absence of trade usages in the narrow sense. Moreover, the rules on force majeure under the national law chosen by the parties should be considered by the decision maker applying *lex mercatoria* as articulated rules and as part of the bargain. In such cases, the decision maker should consider the rules of the chosen national law as a form of specific risk allocation between the parties, unless those rules are formulated in the form of vague standards, thereby leading to uncertainty and enabling the power of discretion, i.e. the capacity for abstractions, of the decision maker.

Once enabled to deal with such uncertainty under the terms of the contract and the applicable national law, the decision maker applying *lex mercatoria* will not be obliged to use its capacity for abstractions within the framework of the relevant national legal system by following its self-referential legal structures. The general contracting practices should rather have a significant influence on the exercise of its capacity for abstractions by the decision maker applying *lex mercatoria* as indications of the reasonable expectations of the parties. Thus, the chosen national law or the applicable national law pursuant to the established rules of conflict can be interpreted and applied by the decision makers in a way that corresponds with the general characteristics of international contracting practices.

It is observed that international contracts which make no particular stipulation and leave these matters entirely to the applicable law are very rare.²⁰⁶² While not all force majeure clauses are drafted the same way, the basic premise that appears with significant frequency in international contracting practices is that the parties understand the force majeure excuse as an issue of risk allocation in the regulation of its requirements and effects. This premise can be found not only in the standard contracts and clauses prepared by international organizations, but also in a spontaneous way in individual contracts.²⁰⁶³ As the reasonable expectations of the parties to international contracts require that an interpretation in line with the general practice is to be preferred to an interpretation strictly in line with the applicable national law, the decision maker applying *lex mercatoria* should approach the issues of force majeure excuse as a matter of risk allocation between the parties.

a. Requirements of Force Majeure Excuse

The burden of proving the requirements of the force majeure excuse is naturally placed on the party relying on it. This burden of proof can become lighter in the events that are so obvious or notorious that proof is not required.²⁰⁶⁴ In accordance with the contractual risk allocation

²⁰⁶² Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 441

²⁰⁶³ *Ibid.*, at 442

²⁰⁶⁴ It is observed that the principle *actori incumbit probatio* has been applied by the arbitrators as a fundamental concept of the international legal community. Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 646; This practice is also recognized in the Article 24 of the UNCITRAL Arbitration Rules. Redfern, Alan & Martin Hunter with Nigel

between the parties, the burden of proof can also be alleviated by the force majeure clauses that contain a list of events, which are agreed by the parties to constitute a force majeure excuse without fulfilling the conditions of its definition. In contrast, the force majeure clause may also require the party who invokes it to provide certain evidentiary means, and such evidentiary means can be interpreted as a contractual requirement for the force majeure excuse in a particular case. In ICC Case No 3880, the sale contract between the parties required that the force majeure be proven by a certificate of the competent Romanian authorities. The defendant seller contended that to the extent that the contract obliged it to supply goods made at a certain factory in Romania, which was the source proposed by its supplier, the default of its supplier constituted an insurmountable obstacle and an extraneous cause relieving it of any liability towards the claimant buyer. The arbitral tribunal stated that in the absence of evidence to the contrary, “delay on the part of one's supplier is a foreseeable contingency”, and the defendant did not prove that “it could not . . . have foreseen or mitigated the consequences of a delay in delivery by [its supplier]”.²⁰⁶⁵ The tribunal considered that “This interpretation of the will of the parties is confirmed by the 'force majeure' clause” to the extent that “this clause requires that the force majeure be proven by a certificate of the competent Romanian authorities”. Thus, the evidentiary means specified by the parties in the force majeure clause were interpreted by the arbitral tribunal in support of the conclusion that the parties did not intend the default of the supplier of the defendant to constitute an event of force majeure for the defendant, unless such default might be characterized in this way for the Romanian enterprise itself, which could be certified by the Romanian authorities.²⁰⁶⁶

Under an abstract reasoning, which considers force majeure as an issue of risk allocation, the decision maker applying *lex mercatoria* should seek for the fulfillment of two basic requirements, unless otherwise specifically provided by the parties in the terms of the contract or in the applicable default rules. The first basic requirement of force majeure is that the event must prevent the obligor from performing any of its obligations, and the obligor is required to prove the causal link between the event and non-performance. The merely impractical or onerous nature of performance due to the changed circumstances will not amount to a force majeure excuse. For instance, as the international contracts are particularly susceptible to price or currency fluctuations, those events should be considered as inherent elements of international commerce and, even a drastic price change will not generally constitute a force majeure event. Particularly, a fixed price can be viewed as a reciprocal allocation of risk of price fluctuations.²⁰⁶⁷

In ICC Case No 11265, the dispute arose from a contract for the supply of petroleum products needed by the claimant to perform a procurement contract with the government of an African state. The claimant alleged that it was unable to fulfill its obligations towards the government

Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 353

²⁰⁶⁵ ICC Award in Case No. 3880, *Yearbook Commercial Arbitration*, (1985), at 45

²⁰⁶⁶ *Ibid.*, at 46

²⁰⁶⁷ ICC Award in Case No. 2708, *Journal du Droit International*, (1977), at 943: The arbitrator, applying French law, found that the increased market value of a product did not relieve the Belgian seller of its obligation to deliver it to a Japanese firm. Referring to the price fluctuation, the arbitrator stated that, especially in the field of international commerce, circumstantial changes constitute one of the most important incentives for contracting, as each party expecting to profit from changes in the market and at the same time implicitly accepting the risk that the change may be unfavorable.

due to the defendant's failure to supply the required quantities of petroleum within the time limit. The defendant relied on the force majeure clause contained in the contract and argued that its failure to perform was due to problems relating to rail transport and the availability of trucks. The tribunal was of the opinion that the transport problems encountered by the defendant did not constitute a case of force majeure.²⁰⁶⁸ According to the tribunal, the defendant assumed a considerable risk under the contract by engaging to have a certain number of cars available, while it could and should have taken into account the likelihood of being faced with serious transport problems in the event that these cars would arrive late. The tribunal noted that, the parties contemplated rail transportation at the conclusion of the contract, but, in its view, once the defendant could not reasonably be unaware that this means of transportation was unsatisfactory due to the alleged problems, the defendant should have taken the steps to alleviate the difficulties posed by the rail transportation. However, the defendant delayed in taking those steps and the tribunal did not consider that delay was justified by the defendant's conviction that the situation in the railroads could improve. The tribunal found that the defendant's reasons for not organizing transportation by trucks sooner were clearly related to the higher cost of the road transportation. Thus, the road transportation was not arranged until assurance had been obtained from the claimant that the latter would cover the additional cost represented by such transport. According to the tribunal, it was beyond doubt that the defendant weighed up the amount it could be required to pay as a penalty under the contract against the additional cost of transportation by trucks, and preferred to take the risk of having to pay a penalty.²⁰⁶⁹

Whether the situations of subjective content constitute force majeure events will depend on the character of the obligation undertaken by the party invoking the force majeure excuse. Unless the contract strictly requires the obligor to perform its obligations personally or through its own organization and the supervening event renders such performance impossible, the obligor may not be excused from its non-performance. In ICC Case No 3952, concerning a contract of delivery of crude oil, one party claimed force majeure, due to the fact that his own supplier had not delivered the necessary quantity of oil. The arbitrators, after having declared that delivery of such a fungible product as crude oil was never impossible, decided that if non-performance of a delivery obligation by a third supplier was to be qualified as force majeure, it must have been expressly stipulated in the contract: it had been negligence on the part of the defendant not to assure other supplies. Moreover, the tribunal rejected the argument that the shifting from one supplier to another would have caused high costs, since the actual price difference of over one third of the market price was not enough to be recognized as an excuse and to relieve the seller from delivery.²⁰⁷⁰

²⁰⁶⁸ As the parties' contract contained no choice of law clause, the arbitral tribunal decided to apply the UNIDROIT Principles. The tribunal noted that the force majeure clause of the contract principally contained an open list of events qualifying as force majeure, but did not give a definition of force majeure, simply referring to usages in the context of the list it contained. Thus, the tribunal decided to read the force majeure clause of the contract in the light of the rule laid down in Article 7.1.7 of the UNIDROIT Principles. The tribunal considered that the event must be unpredictable at the time the contract was concluded from the perspective of a normally diligent and reasonable professional, it must be beyond the debtor's control or influence, and it must be of such a kind that the debtor could not reasonably be expected to anticipate or overcome it or anticipate or overcome its consequences. The tribunal considered that these conditions were not satisfied in the case and that the defendant did not face with any of the events mentioned in the force majeure clause of the contract. ICC Final Award in Case No 11265, October 2003, ICC International Court of Arbitration Bulletin, 20-2 (2009), at 89

²⁰⁶⁹ Ibid.

²⁰⁷⁰ ICC Award in Case No. 3952, 1982, (unpublished), cited by Melis, Werner, Force Majeure and Hardship Clauses in International Commercial Contracts in View of the Practices of the ICC Court of Arbitration, *Journal of International Arbitration* 1 (1984), at 221

In ICC Case No 9978, a dispute arose as a result of non-delivery of the goods under the contract of sale between the claimant, purchaser, and the defendant, seller. The defendant argued that it was not the owner of the goods at the time of conclusion of the contract and invoked force majeure excuse. The arbitral tribunal held that CISG was applicable. The tribunal stated that “non-delivery by a supplier does not fall under the concept of exemption from liability laid down in Art. 79 CISG or the force majeure clause contained in the contract. The contract clearly indicates that the goods sold were not a specific lot, but generic goods . . . In this case, the risk of non-delivery by its supplier ("procurement risk") is clearly on the seller... This is in line with the constant practice of ICC arbitrators who grant force majeure defences only in extreme cases such as war, strikes, riots, embargoes or other incidences listed in the force majeure clause of the contract. In cases of impediments to performance related to the typical commercial risks involved in the transaction, however, they uphold the principle of "pacta sunt servanda", thus preserving the sanctity of the contract as the magna charta of international contract law”.²⁰⁷¹

Whether such other events as economic impossibility or impracticability excuse the non-performance of the contractual obligations should be determined on the basis of the position of the established rules in the particular case. Where the decision maker have found a national law as governing the substance of the dispute by means of the application of *lex mercatoria* at the conflict of laws stage, the relevant rules of this national law should be taken as indicating the established rules in the particular case, and should govern the necessary extent of obstacles excusing the obligor from performing its obligations. The issue of idiosyncrasy in the applicable national rules will not arise in this respect due to the divergence of approaches, which can be found in national legal systems and even in international contracting practices, in relation to what is understood by the concept of impossibility. Such a divergence precludes discovering such rules that are established in the order of international commerce. In cases where the decision maker has decided to apply *lex mercatoria* exclusively to the substance of the dispute, the decision maker should favor the conclusion that the force majeure excuse requires the performance of the obligations to become legally, factually or physically impossible in an objective sense, in view of the position of the international instruments, which assist his abstract reasoning, to the issues of force majeure.²⁰⁷²

²⁰⁷¹ ICC Final Award in Case No 9978, March 1999, ICC International Court of Arbitration Bulletin, 11-2 (2000), at 117

²⁰⁷² Perillo, Joseph M., Force Majeure and Hardship under the UNIDROIT Principles of International Commercial Contracts, in *Contratación internacional, Comentarios a los Principios sobre los Contratos Comerciales Internacionales del Unidroit*, Universidad Nacional Autónoma de México - Universidad Panamericana, 1998, at 121-122: “What if the impediment is caused by the party's financial embarrassment? Neither Article 7.1.7 [of the UNIDROIT Principles] nor the commentary to it refers to this kind of impediment. Under American law, it is quite clear that financial impediments provide no excuse; these are regarded as "subjective" rather than "objective" impossibility and there is unanimity in the case law and in doctrine that subjective impossibility provides no excuse, whether or not it was the result of conditions outside the control of the obligor. It is generally believed that the risk of financial ability to perform is such a basic assumption underlying all contracts that it cannot be excused, except by a decree in a bankruptcy proceeding. It is hard to believe that this general belief is suspended in international trade.” Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 378: “While insolvency would not normally be an impediment within the meaning of the text, as it is not 'beyond the control' of the debtor, a government ban on transferring the sum due might be.” Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 651: “Arbitrators have distinguished impossibility from mere impracticability or onerousness. A party's inability to perform will not constitute impossibility if, in an objective sense, someone else could perform.”

The second basic requirement of force majeure excuse is that the effect of the alleged event on the contractual obligations must be outside of the control of the obligor. Thus, a party cannot rely on a force majeure excuse if it first created the impossibility and then sought to invoke it as a defense. This concept is particularly relevant in the context of disputes arising from state contracts, where the investors often dispute the proposition that governmental intervention is entitled to recognition as a supervening event uncontrollable by the parties.²⁰⁷³ This requirement also implies that the event must be both unforeseeable and unavoidable. If the event was foreseeable at the time of the conclusion of the contract, the obligor could control its effect on its contractual obligation through the reallocation of the relevant risk, such as by negotiating for an explicit contractual clause providing that the materialization of the relevant risk will excuse the non-performance. In ICC Case No 2216, the Norwegian buyer of crude oil refused to perform the contract, arguing, among others, that it did not get the necessary authorizations to obtain foreign exchange from Norwegian authorities. The arbitral tribunal stated that an event of force majeure requires the characteristics of unforeseeability and irresistibility. The tribunal noted that the agreement did not include any reservations in relation to the Norwegian exchange control regulations and the relevant legislation had been in force before the contracts had been concluded. Thus, the buyer was therefore fully aware of the fact that authorizations might not have been given for a specific transaction, and assumed the relevant risk. The tribunal further found that the buyer failed to inform the seller the exchange control requirements, and this failure resulted from its negligence. In this regard, the tribunal pointed out that the agreement expressly excluded the force majeure excuse, where the event involved fault or negligence of the parties. Thus, the tribunal held the buyer responsible for breach of contract.²⁰⁷⁴

In the ICSID Case of *Autopista Concesionada de Venezuela, C.A. v. Bolivarian Republic of Venezuela*, the tribunal, considering past experiences in Venezuela, implied that the government has foreseen and, thus, assumed the risk of the interference of civil protests with the performance of the concession agreement. The concession agreement was concluded between Aucoven, and Venezuela, under which Aucoven was to design, construct, operate, exploit, conserve, and maintain a highway system in Venezuela. The concession agreement granted Aucoven the exclusive right to collect tolls from highway users. The toll income would repay Aucoven's investment, and finance the operation and maintenance of the highway system. To accomplish these goals, Venezuela agreed to increase the highway tolls according to a scheme. However, some toll increases agreed by the parties were not implemented by Venezuela because of major public protests against the planned increases. Venezuela argued that its inability to increase toll rates was excused by force majeure. The arbitral tribunal held that the dispute must be resolved by application of the Venezuelan law, pursuant to the second sentence of Article 42(1) of the ICSID Convention, while international law would prevail over conflicting national rules.²⁰⁷⁵

The tribunal noted that the contractual force majeure defined in Clause 41(2) of the concession agreement addressed the situation in which Aucoven is prevented from performing due to a force majeure event that affects itself, but it did not deal with a situation where Venezuela's performance becomes impossible as a result of force majeure. Thus, the tribunal

²⁰⁷³ Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 653

²⁰⁷⁴ ICC Award in Case No.2216, *Journal du Droit International*, (1975), at 917-919

²⁰⁷⁵ *Autopista Concesionada de Venezuela, C.A. v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/00/5), Award of the Tribunal (September 23, 2003), para. 105

decided to assess the consequences of force majeure according to the applicable law. The parties agreed that force majeure was a valid excuse for the non-performance of a contractual obligation in both Venezuelan and international law, and the following conditions must be fulfilled for a force majeure excuse: impossibility, i.e., “the *force majeure* event made performance impossible to achieve”; unforeseeability, i.e., “the *force majeure* event was not foreseeable”; and non-attributability, i.e., “the *force majeure* event was not attributable to the defeating party”.²⁰⁷⁶ The tribunal held that it was up to Venezuela, which relies upon the force majeure excuse, to prove that the conditions of force majeure were met.

As to the condition of unforeseeability, considering the impact of the Caracazo, which was a political phenomenon that occurred in 1989 following an increase in the price of gasoline and, consequently, the price of transportation, on Venezuelan society in general, the tribunal stated that “one cannot reasonably argue that Venezuelan officials negotiating the Agreement could ignore that the increase in transportation price resulting from the contractual mechanism of toll rate increase could at least potentially lead to violent popular protest similar to the one of 1989.”²⁰⁷⁷ The tribunal found additional support for this view in Venezuela’s submission that “[s]oon after the parties signed the Contract and before any attempt to implement any toll increases, it became apparent that strong public resistance to toll increases could imperil the Concession’s future”, and noted that Venezuela did not establish, or even explain, the reasons why the strong public resistance was apparent shortly after the signature of the agreement and before any actual attempt to increase the tolls, while it was unforeseeable shortly before during the negotiation of the contract. Thus, the tribunal was not convinced that the possibility of strong popular resistance to toll increase became apparent only after the conclusion of the concession agreement.²⁰⁷⁸ The tribunal held that “For lack of unforeseeability, Venezuela’s non-performance cannot be excused on the ground of force majeure. Hence, whether the conditions of impossibility and attributability are met is not decisive.”²⁰⁷⁹

The consideration that the consequences of an event are avoidable implies that the obligor has some control over the effect of the event on the contractual obligations. Depending on whether the costs of the required efforts can be considered as being covered by the bargain underlying the contract on the basis of the articulated or established rules in a particular case, the obligor may be expected either to avoid or remove the effect of the event during the course of contract. In ICC Case No 1782, a German company, which had to deliver trucks to an Arab country and to maintain them, refused to perform its obligation of maintenance, after delivery, on the ground of force majeure because its employees of Jewish origin did not obtain the necessary visas. The tribunal ruled that the event did not make performance impossible as the German company could have taken appropriate measures to ensure the effective maintenance of the vehicles, as it had found a way to clear the vehicles by means of a third company in order to perform its obligation to deliver them. According to the tribunal, the German company could, similarly, find a way to honor its obligation to provide maintenance by hiring other personnel to maintain the trucks or assigning this part of the contractual obligation to a subcontractor.²⁰⁸⁰ Thus, the subsequent conduct of the German company as to the delivery of trucks indicated that it assumed the costs of avoiding the effect

²⁰⁷⁶ Ibid., para. 108

²⁰⁷⁷ Ibid., para.115

²⁰⁷⁸ Ibid., para.116

²⁰⁷⁹ Ibid., para. 119

²⁰⁸⁰ ICC Award in Case No. 1782, *Journal du Droit International*, (1975), at 923

of the alleged event of force majeure, such as ensuring the effective maintenance of the vehicles by means of a sub-contract.

The determination of the existence of the unforeseeability and unavailability depends on the contract and the presumption about the parties' competences, which will be determined on the basis of the test of reasonable persons of the same kind as the parties placed under the same circumstances, through the contextual approach of the decision maker. It is argued that the repeated use of certain analytical criteria in arbitral awards dealing with force majeure recognize a standard of behavior for international merchants, which is conducive to establishing authoritative customary rules of *lex mercatoria*.²⁰⁸¹ In essence, the arbitral awards suggest the significance of the reasonableness in determining whether the conditions of unforeseeability and unavailability were satisfied in a particular case. The arbitral tribunals, by exercising an abstract reasoning, generally require the obligor to exercise the foresight expected from a reasonable person of the same kind in the same circumstances, and to assume the costs of such efforts as would be made by a reasonable person of the same kind in the same circumstances, to avoid the effect of alleged event of force majeure on the performance of its obligations.

In the related ICC Cases No 2139 and No 2142, a government nationalized a foreign corporation's source of raw materials, and subsequently contracted to sell a quantity of the same material to other foreign corporations. The company suffering the nationalization threatened seizure of all such materials sold by the government in the event that those materials were sold on the international market. Some of the prospective buyers argued that the threats constituted force majeure excusing their non-compliance with the purchase agreements, and they refused to carry out their obligation to take delivery of the materials sold. Invoking the arbitration clause contained in the sale contracts, the state enterprise concerned sought compensation for the injury caused. The arbitrators were led to make several awards, in all of which the plea of force majeure invoked by the defaulting buyers was rejected. In both cases of 2139 and 2142, the force majeure argument was rejected on the ground that the conditions of unforeseeability and unavailability were not satisfied.

The tribunal in ICC Case No 2139 defined a case of force majeure as an event "with aspects of unforeseeability (that is to say, when it happened, there was no particular reason to suppose that the event would occur) and irresistibility (that is to say, it was absolutely impossible for the defendant to perform the contract)". The tribunal found that "the contract was concluded on ... [date] and that at that time the crisis ... which followed the nationalization ... had already begun and therefore could not comprise the aspect of unforeseeability required by the law". Noting that "[the state enterprise] has proven ... that at that same period, other buyers were regularly lifting the oil cargoes which they had purchased", the tribunal decided that "X... cannot claim that there was a case of force majeure making it impossible for X to perform the contract" and held the defendant responsible for the non-performance of its contractual obligations.²⁰⁸² In ICC Case No 2142, the tribunal found that the event did not have "the characteristics of enforceability and unsurmountability necessary to constitute force majeure" because at the date of the signature of the contract, the crisis following upon the nationalizations was of public notoriety and was the object of numerous articles in the press, and even of governmental declarations, and there was evidence that at the same period other

²⁰⁸¹ Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 651

²⁰⁸² ICC Award in Case No. 2139, *Yearbook Commercial Arbitration*, (1978), at 221

purchasers regularly collected and transported the quantities of the product of which they had become purchasers. Thus, the tribunal held that “the elements which constitute force majeure are thus in no way reunited and that it is therefore appropriate to reject as inapplicable the argument drawn from force majeure”.²⁰⁸³

The test of reasonable persons of the same kind as the parties placed under the same circumstances was central to the reasoning of the tribunal in ICC Case No 4462. The case concerned an Exploration and Production Sharing Agreement (“EPSA”) between National Oil Corporation (“NOC”) in Libya and Sun Oil, under which Sun Oil was to undertake, finance and carry out an oil exploration program and to receive a share of the petroleum production. The EPSA was concluded for a term of 20 years and it was to be governed by and interpreted in accordance with Libyan law. Article 22.1 of the EPSA provided that “Any failure or delay on the part of a Party in the performance of its obligations or duties hereunder shall be excused to the extent attributable to force majeure. Force majeure shall include, without limitation: Acts of God, insurrection, riots, war, and any unforeseen circumstances and acts beyond the control of such Party.” Under Article 22.2, if operations were delayed, curtailed or prevented by force majeure, and the time for carrying out obligations under the EPSA was thereby affected, the term of the EPSA would be extended, but either party could terminate the EPSA upon written notice to the other if the fulfillment of the obligations of either party was affected by force majeure for the periods specified in the agreement. On the basis of these provisions, Sun Oil suspended performance, arguing that its personnel, all of whom were US citizens, could not enter Libya after the US Government instituted an order declaring that US passports were no longer valid for travel to Libya, and Sun Oil’s application for a license to export oil technology was denied as a result of the US export regulations, which was enacted after the conclusion of the EPSA.²⁰⁸⁴

The arbitral tribunal considered that the expression “force majeure” covers a legal notion, which is reflected in Article 360 of the Libyan Civil Code and, the effect of force majeure is to release the obligor from his obligation under the agreement and force majeure is established when an event meeting the three following conditions occurs: (i) being beyond the control of the parties, (ii) being unforeseeable at the time the agreement is entered into and (iii) rendering the performance of the obligation absolutely impossible. The tribunal noted that Article 360 is not “a public order provision” and the contracting parties are entirely free either to exclude force majeure or, on the contrary, to make its conditions more flexible. The tribunal stated that “This is the mere application of the principle according to which the contract constitutes the law between the parties, which principle is contained in Art. 147 of the Libyan Civil Code.”²⁰⁸⁵

While both parties referred to the force majeure clause set forth in the EPSA, they disagreed on the meaning and the consequences entailed by such clause. According to Sun Oil, Article 22 would be self-sufficient and would set up a specific force majeure regime, much more flexible and liberal than the one provided for under Article 360 of the Libyan Civil Code. Sun Oil argued that Article 22 expressly defined force majeure events as any “unforeseen” circumstances beyond the control of the party invoking force majeure and there was “no way to glean a requirement of unforeseeability”. Sun Oil also stated that Article 22 nowhere

²⁰⁸³ ICC Award in Case No. 2142, Yearbook Commercial Arbitration, (1976), at 132

²⁰⁸⁴ ICC Award in ICC Case No. 4462, International Legal Materials, (1990), at 568-575

²⁰⁸⁵ Ibid., at 584

mentioned the word “impossible”, and concluded that “Article 22 clearly is not limited to circumstances in which performance is absolutely, objectively and unqualifiedly “impossible”.”²⁰⁸⁶ Finally, according to Sun Oil, there was a clear distinction between extinguishment of the obligations of the parties under Article 360 of the Libyan Civil Code and “extension” of the time for “carrying out obligations” of the parties under Article 22 of the EPSA, which indicated that the effect of a force majeure event under Article 22 was defined “less strictly” than under Article 360. NOC argued that when using the expression “force majeure”, the parties were deemed to give it its usual meaning, unless the agreement expressly provided for the contrary. According to NOC, where the parties referred to the concept of force majeure in Article 22 and did not expressly exclude any of the conditions of force majeure required under Libyan common law, it would not be sufficient for such event to have been unforeseen and beyond the control of the parties, but the event should also meet the other criteria of force majeure under Libyan law. According to NOC, under Libyan law, the impossibility to perform must be absolute, in the sense that “there were no alternative means available” which would make it possible to achieve contractual objectives, the party invoking the force majeure would also have to prove that the event was irresistible, and the unforeseeability requirement would have to be examined objectively and strictly by reference to what a very vigilant person would have foreseen.²⁰⁸⁷

According to the tribunal, the fact that the parties felt it necessary to include in the EPSA a force majeure clause demonstrated that they were not satisfied with the mere application of the rules of the Libyan Civil Code, but their common intention was not obvious when reading Article 22 of the EPSA for the lack of a definition of “force majeure”. The tribunal considered the reference to “any unforeseen circumstances and acts beyond the control of the party” as being extensive and proving “without any doubt the intent of the parties to extend the scope of force majeure beyond the cases traditionally deemed to constitute an irresistible occurrence (war, natural disasters etc.).” The tribunal stated that “In this respect, it reflects a certain trend, which is displayed to a greater or lesser extent in long term international contracts, to define force majeure less strictly than under most domestic contracts. It still remains to define how far did the parties intend to go in making this approach more flexible.”²⁰⁸⁸

The tribunal did not exclude the possibility that, in selecting the adjective “unforeseen” instead of “unforeseeable”, Sun Oil and NOC expressed their intention to exclude the requirement of unforeseeability or at least, not to give to such a requirement a strict meaning. However, with regard to the condition of “impossibility of performance” required under general Libyan law, the tribunal considered that the interpretation that any circumstance beyond the control of the parties would excuse the nonperformance of the obligation or the delay in performing subject to the sole condition that such circumstance was not foreseen was difficult to be admitted, because it would result in allowing the enforceability of contractual obligations to be challenged upon the occurrence of the slightest difficulty and neither party made such an argument. The tribunal stated that “It is true that more and more international long term agreements contain provisions according to which is considered as an event of force majeure any event beyond the control of the parties which renders the performance of the agreement very difficult and/or more expensive than anticipated or any event which cannot be overcome by the use of reasonable means at reasonable costs. Such provisions when agreed

²⁰⁸⁶ Ibid., at 585

²⁰⁸⁷ Ibid., at 586

²⁰⁸⁸ Ibid., at 587

upon, leave no doubt as to the intent of the parties. They clearly reflect that the parties intended to avoid that the impossibility to perform be considered as the *sine qua non* requirement for force majeure. However, in order to be accepted, such exceptions to the common law of force majeure must be expressly provided for; they should not be presumed or implied.”²⁰⁸⁹

The tribunal concluded that “it would be unjustified, in the absence of any specific provision to such effect in Art. 22, to construe such article as revealing an intent of the parties to waive an essential rule of Libyan common law according to which force majeure is only established when the event invoked by the defaulting party created an impossibility to perform whether on a temporary or a permanent basis.” According to the tribunal, this was clearly what Sun Oil seemed to have understood because in its telex to NOC, it stated that “the applicable US passport and export regulations have made it impossible for it to perform under the contract”.²⁰⁹⁰ Thus, the tribunal held that Article 22 expressed the intent of the parties not to strictly apply the usual criteria of force majeure, in particular with respect to the unforeseeability requirement, but that it did not exclude the fundamental requirement that the event must have rendered definitively or temporarily impossible the performance of the contractual obligations.

The tribunal then examined Libyan case law on force majeure and especially “the leading case on such matter”, the Libyan Supreme Court decision in the *Latsis* case, dated 20 June 1971. It concluded that: “The oral and written testimonies of the experts on Libyan law submitted on this subject as well as a careful examination of the *Latsis* case leave no doubt as to the fact that, under Libyan Civil Law, the impossibility must not be determined subjectively, i.e., by reference to the capabilities and personal means available to the defaulting obligor but rather objectively. It is because of such meaning that the impossibility is said to be ‘absolute’ However, one should only compare what can be compared. The question is not to take as a reference an ideal and purely abstract type of obligor. The comparison can only be established with an obligor being liable for obligations of the same nature and of the same importance as those of the defaulting obligor, and who would be faced with the same difficulties. This also results from the *Latsis* case and from the experts’ testimonies. Under this approach, one is led to believe that, under the meaning of Art. 22, non-performance by a party or delay in performing contractual obligations is excused when an unforeseen circumstance beyond the control of the parties occur, which circumstance constitutes an obstacle such that an obligor, normally diligent, having the same obligations and placed in the same situation, could not have overcome it.”²⁰⁹¹

The tribunal held that, in view of the meaning of Article 22, Sun Oil, which has the burden of proof, must show evidence that each of the two regulations successively enacted by the U.S. Government did constitute (i) a circumstance ‘beyond the control’ of the parties, (ii) an ‘unforeseen circumstance’ and (iii) an impossibility to continue exploration. According to the tribunal, the first requirement was certainly met since the regulations were acts of government and thus clearly beyond the control of the parties. As to the second requirement, the tribunal considered that both regulations constitute unforeseen circumstances at the time the agreement was signed given that, while the relations between the United States and Libya had

²⁰⁸⁹ Ibid., at 588

²⁰⁹⁰ Ibid.

²⁰⁹¹ Ibid., at 589

already been through difficult times before that date, political tensions between the two countries had so far left untouched the commercial relations in the area of petroleum business. According to the tribunal, third requirement was the crucial point, and the particular question was whether there was any solution for Sun Oil, any possible avenue other than the mere discontinuance of exploration. For that purpose, the tribunal considered that the nature and scope of obligations of Sun Oil should be accurately defined in order to assess the impact which the two regulations in question had on those obligations.²⁰⁹²

As to the passport order, the tribunal was willing to admit that, upon signing the EPSA, it was assumed by both parties that Sun Oil would carry out the exploration with its own management and personnel and the majority of Sun Oil's personnel were American citizens, but the tribunal also noted that, it was at all times possible for Sun Oil to hire non-US personnel, and it was not proven that the possibility to use non-US personnel was outside the intention of the parties.²⁰⁹³ Sun Oil argued that it is the universal practice in the oil industry for a company to rely on its own management and personnel in a major exploration operation. However, there was no evidence tending to show that a major oil company doing business on an international scale was expected to perform its exploration obligations only by way of utilizing technical and scientific personnel carrying passports of the company's home country, and there was a lot of testimony tending to show the contrary.²⁰⁹⁴

As to the export regulation, on the basis of the evidence submitted, the tribunal accepted the following facts: Sun Oil's application for export license was sincere; due to the denial of such application, Sun Oil was prohibited from making available to its exploration team on site the result of the technical operations carried out in the US; and Sun Oil was also prohibited from disclosing to NOC in Libya or in any other place, information on its analysis processes. According to the tribunal, these facts were relevant only to the extent it was established that both parties had agreed that the only technical means which were to be used were those of the US center of Sun Oil.²⁰⁹⁵ According to Sun Oil, it could not resort to techniques other than its own as it is a rule in the oil industry that the operator uses its own personnel and its own technical resources for its exploration operations. The tribunal stated that "as a matter of practice in the oil industry, major companies which undertake at their risks and expenses to explore for oil would insist on using their own techniques in order to obtain the expected results and would generally not entrust contractors with Exploration Operations without retaining supervisory and management control. Therefore, there is no reason to question the fact that it was Sun Oil's intent to use its own processes to complete the delicate task of analysing and coordinating all technical data (seismic and other), allowing to locate the oil fields and evaluate the size thereof." However, the tribunal still questioned the possibility to infer that this use by Sun Oil of its own technological resources was an "essential condition of the contract" and to conclude that the only mode of performing the EPSA commonly contemplated by the two parties was through the use of Sun Oil's own in-house technology.²⁰⁹⁶ Thus, although Libyan law required the condition of objective impossibility for the force majeure excuse, the tribunal seemed to be prepared to accept a subjective impossibility as excusing the non-performance if the common intentions of the parties

²⁰⁹² Ibid., at 590

²⁰⁹³ Ibid., at 592

²⁰⁹⁴ Ibid., at 594

²⁰⁹⁵ Ibid., at 595

²⁰⁹⁶ Ibid., at 596

indicated that it was an essential condition of the contract and of the underlying bargain that the relevant obligation was to be performed through Sun Oil's own organization, in which case its non-performance could have been excused, because the obligation would have been fundamentally changed due to the US regulations.

However, according to the tribunal, the language of the EPSA indicated that it was the common intention of the parties to confer on Sun Oil, as operator, the broadest possible flexibility and discretion in selecting appropriate technologies, contractors, consultants, scientists and technical personnel. The tribunal held that the essential condition of the agreement was that Sun Oil, who was responsible for the exploration, had to complete the exploration program diligently and in a manner consistent with modern petroleum industry practices. In support of this finding, the tribunal noted that the costs of the efforts expected from Sun Oil to continue the performance of its obligations despite the US export regulations were covered by the EPSA, which conferred on Sun Oil a virtually unlimited power to engage, and charge to the operating account, as costs and expenses: "The service of consultants, contract services, utilities and other services procured from outside sources".²⁰⁹⁷ According to the tribunal, Sun Oil's processes were not unique, and it could find on the oil market the support necessary to complete the exploration program with technological resources, which, while being consistent with modern practices, would not have been subject to the US Export Regulation. The tribunal observed that the other American companies, which had been engaged, at that time, in similar exploration operations, under similar EPSAs, did not discontinue the exploration on the basis of force majeure, but on the contrary, found ways to continue the exploration despite the US Export Regulation, which was binding on them as it was binding on Sun Oil. Thus, the tribunal applied the test of whether a reasonable person placed in the same circumstances as the party seeking to be excused would have been able, despite the supervening event, to perform the contract. The tribunal noted that normally, the judge must refer to a theoretical reasonable person but, according to the tribunal, in this case, there was an unusual situation in which parties placed in the same circumstances existed in reality and had been able to overcome the supervening obstacle to performance. Thus, the tribunal concluded that the US Export Regulations did not constitute for Sun Oil an event of force majeure excusing the discontinuance of exploration for such time as such regulations would remain in force, whether viewed separately or in connection with the passport order.²⁰⁹⁸ The tribunal held that the passport order and/or export regulations in question did not constitute events of "force majeure" within the meaning of Article 22.1 of the EPSA and did not excuse Sun Oil's cessation of performance under the EPSA.²⁰⁹⁹

In the joined ICC Cases No 3099 and 3100, the arbitral tribunal emphasized the relationship between the issue of foreseeability and the risk allocation between the parties. The dispute arose from two contracts for the purchase of refined oil products and crude oil between an Algerian state enterprise, as the seller, and an African state enterprise, as the buyer. The contracts provided that Algerian law was applicable. The buyer could not meet its payment obligations under the contracts, and invoked the force majeure clause contained the contracts. The buyer declared that it had in its bank the necessary sums for payment, but could not obtain, in spite of several representations to the Central Bank of its country, the authorization for payment. The buyer therefore stated that, without any fault on its part, it found it

²⁰⁹⁷ Ibid., at 597

²⁰⁹⁸ Ibid., at 598

²⁰⁹⁹ Ibid., at 599

impossible to realize the payments. The arbitral tribunal stated that “Lacking a general definition of the concept of force majeure in the contractual ... and legal texts, the arbitral tribunal must turn to jurisprudence and doctrine. In French law, force majeure is an unforeseeable and unavoidable event which comes generally from outside the person who invokes it. The concept is therefore defined by its three characteristics: externality, unavoidability and unforeseeability”.²¹⁰⁰

The tribunal found that the foreign exchange regulations at the buyer’s country and, in particular, the requirement of a previous authorization by the Central Bank of the buyer’s country for the payment in foreign currency of the amounts due were already in force at the moment that the two sales contracts were concluded. Moreover, the tribunal stated that “[the buyer] knew — or at least should have known — that its country found itself in a difficult monetary situation and that the Central Bank would perhaps not be in a position, when invoices became due, to provide the necessary foreign exchange. This is a risk which the [buyer] could not ignore, taking into account the exceptional importance and the frequency of the payments to be made in US dollars. Therefore it was up to [the buyer], and not its bank, to obtain the necessary guarantees from the Central Bank (of its country); either at the moment the contracts were concluded, or at the latest before taking delivery of the refinery products or the crude oil.” The tribunal considered that according to the rules of good faith, the buyer could not bind itself in respect to the seller to pay for the products without having the certainty of being able to effectuate these payments in foreign currency on the dates they became due. The tribunal found that only after having taken delivery of the larger part of the products, the buyer approached the Central Bank in its country, the sole authority empowered to make the necessary foreign currency available to the buyer.²¹⁰¹

The tribunal concluded that “For [the buyer] it is not a case of force majeure that the Central Bank did not provide it with the necessary foreign currency for the payment of the invoices. Moreover, [the buyer] itself is not without fault. It did not, as was warranted by the

²¹⁰⁰ The tribunal first examined in fact and in law whether the circumstance that the Central Bank of the buyer's country did not make the foreign currency timely available to the buyer should be considered as an exterior event, in view of the seller’s contention that, as the Central Bank and the buyer are both legal persons, falling under the same authority, under whose auspices the contractual relations were established. The tribunal referred to the French Supreme Court’s decision of April 15, 1970, which formulated the principle that the link between the state and the debtor prevents the intervention by the state from being constituted as a “fait du prince”. The tribunal found that the two sales contracts, at the personal initiative of the Head of State of the buyer's country, were negotiated and signed by one of the Presidential Counselors of that country and not by the buyer’s responsible organs. Thus, according to the tribunal, the principle formulated by the French Supreme Court in that decision should therefore be applied to the present case, particularly for the security of international contracts. However, the force majeure clause in the contracts provided that “The parties will not pay any losses and damages, of whatever nature which have arisen from any delay or default in the performance of the obligations of the contract caused by force majeure, unless there is, however, fault or negligence on the side of the party who invokes force majeure. For the purpose of the contract a case of force majeure will exist especially when the seller or the buyer complies with any provision or measure resulting either from the text of a law or a regulation issued by any public authority in Algeria, or from an international agreement to which Algeria is a party, irrespective of whether the validity or application of such text or such agreement is contested or not.” Thus, the arbitral tribunal noted that the seller, which was also an entity of public law or mixed law, submitted to the guardianship of the Algerian state, had reserved for itself in the force majeure clause, the possibility of bringing forward the Algerian state’s intervention as a case of force majeure. Thus, in view of the tribunal, it appeared doubtful that the seller would be able to deny the buyer to invoke the default of the Central Bank of its country as the intervention of a third person, extraneous to it. However, the tribunal did not deal with this question since it found that the element of unforeseeability was lacking. ICC Award in Cases No. 3099 and 3100, Yearbook Commercial Arbitration (1982), at 90-91

²¹⁰¹ Ibid., at 92

circumstances, take the precaution of obtaining from the Central Bank the assurance that it would receive this currency. In this way the [buyer] made a relatively grave mistake which should be attributed to it, and not to its bank. Indeed, in view of the exceptional importance of the amounts to be paid, it is [the buyer] who should have made arrangements that the payments in US \$ could be effectuated within the contractual time limit.”²¹⁰² Thus, the tribunal rejected the force majeure excuse because the element of unforeseeability was lacking. The relevant exchange control legislation was already in force before the contracts had been concluded, and it was regarded as the duty of the buyer to undertake the reasonable steps to get the foreign exchange transfer permissions.

The arbitral tribunal in ICC Case No. 12112 also considered, as an element of the condition of foreseeability and risk allocation, the obligor’s duty to take reasonable steps to be certain of its capacity for performance before binding itself in respect to the obligee to perform certain obligations. The dispute arose from a joint venture agreement concluded between the foreign investors and the Ministry of Agriculture of State Y for the cultivation of agricultural products, the breeding of livestock and the processing and sale of the resulting products. The joint venture company (“Company X”) experienced serious difficulties from the start: among other disturbances, the land was occupied by farmers, who in some cases claimed ownership, and the workshops were occupied by protesting wives of workers. The investors commenced ICC arbitration, seeking the dissolution of Company X and damages.²¹⁰³ The sole arbitrator first held that the law of State Y applied to the substance of the dispute. The arbitrator considered the contractual obligations of the parties and concluded that the state partner did not perform under those obligations because it failed to make available the land, the equipment and facilities that were its contribution in kind to the joint venture.²¹⁰⁴

The agreement contained some clauses dealing with the regime of liability and the force majeure excuse. The agreement provided for strict liability regime, according to which non-compliance with any obligation would create liability. The arbitrator noted that State Y provides a regime where fault is the ground of contractual liability, but is presumed in case of any default in performance. The arbitrator considered that the clauses dealing with the force majeure excuse slightly differ in their system from the ordinary statutory regime of State Y law but, under State Y law, impossibility is of no excuse when the performance of the obligation has turned out to be impossible for the fault of the debtor. Thus, the arbitrator decided to examine the question of coordination between those two regimes. He considered that State Y liability regime is a minimum standard and the agreements providing for a liability regime stricter for the nonperforming debtor are valid. The arbitrator found that the two regimes lead anyway to identical results. Article 31 of the agreement provided that the parties would be exempted from the effects of non-compliance with their obligations, “if such non-compliance was the consequence of circumstances of force majeure arising after the conclusion of the contract as a result of extraordinary events which a Party could neither foresee nor avert by reasonable means.” Article 31 defined the expression “circumstances of force majeure” as “events which beyond the Party’s control and for whose occurrence it is not responsible, for example earthquake, flood, fire.” Article 33 of the agreement provided that “The Party which is unable owing to circumstances of force majeure to comply with its

²¹⁰² Ibid.

²¹⁰³ ICC Award in Case No. 12112, *Yearbook Commercial Arbitration* (2009), at 78

²¹⁰⁴ Ibid., at 79

obligations under this Contract, to make up for such non-compliance as quickly as possible.”²¹⁰⁵

The arbitrator stated that the burden of proof of non-performance was caused by force majeure lies on the side of the state partner. The arbitrator observed that the third parties, such as workers, their wives, peasants, who cannot be considered as the state partner’s auxiliaries, whose behavior could be imputed to the state partner, played a role in the disturbance and default of performance, but the state partner did not provide any convincing evidence that explain why the behavior of these third parties was impossible to prevent by reasonable means, or irresistible. The arbitrator required the evidence explaining that all reasonable means to avert the third parties’ behavior had been used by the state party, and describing the reasons why reasonable means were not sufficient and why sufficient means would have been unreasonable. In the absence of such evidence, the arbitrator did not admit that non-performance was caused by “circumstances of force majeure” according to the agreement. The arbitrator also considered that the unstable political, social and economic situation of State Y at the relevant period and the resulting difficulties for performing agreed obligations did not allow him to change the notion of contractual obligation and the concept of force majeure, and to consider that the state partner was liberated simply because of the social unrest in that country, since otherwise any obligation in State Y at that time would have to be considered as subject to force majeure, which would prevent law to be an instrument of stability or contributing to stability. The arbitrator stated that “Nobody forced the State Y partner to agree on the obligations provided for in the Contract after negotiations. Once it had agreed to be bound on such obligations, it could not be liberated from them simply because of the general situation in State Y.”²¹⁰⁶

The arbitrator noted that even if one admitted that the relevant circumstances were impossible to avert by reasonable means, it was not clearly proven by the state partner that these circumstances were unforeseeable for the state partner. The arbitrator stated, with regard to the unforeseeability requirement of force majeure, that “Before entering an obligation, everyone must, before, be certain that he has the ability to perform it. If he has or must have a slightest doubt about his ability to perform at the given time, he must make all necessary verifications before promising performance.”²¹⁰⁷ The arbitrator added that “In such a contract between a state partner and a foreign partner, the foreign partner legitimately relies on the national public partner as to questions of social climate and forces in the concerned region, that the foreign partner cannot estimate properly (this arises clearly out of the principle of good faith, which is central in State Y contract law...; *imperio rationis*, one can refer as well, *per analogiam* and *a fortiori*, to UNIDROIT principles of international commercial contracts, 1994, Art. 6.14 [6.1.14 (Application for public permission) of the UNIDROIT Principles 2010] et seq., with reference to the role of a national contracting party even not public.) If such a national public partner promises by a contract that defined obligations will be performed, its foreign contracting partner can only have the expectation that it will be done so. That is to say that the national public partner has a strict legal duty to check that performance will be possible at the promised time, taking also into consideration the social climate that the foreign partner cannot estimate properly; if it has not made the necessary verification, it must bear all consequences towards its foreign contractual partner.”²¹⁰⁸

²¹⁰⁵ Ibid., at 89

²¹⁰⁶ Ibid., at 90

²¹⁰⁷ Ibid.

²¹⁰⁸ Ibid., at 91

In the case, there was no clear evidence that the social climate had completely changed in an unpredictable way, between the time of negotiations and the time for performance. According to the tribunal, it would have been the duty of the State Y partner to ensure that the regional social forces would not disturb performance of its contribution, by checking and, if necessary, negotiating seriously with them before concluding the contract and entering the obligations. Thus, the arbitrator held that the conditions of the force majeure clause were not fulfilled since it was not proven that the state partner could neither foresee nor avert by reasonable means the circumstances that did not depend on it.²¹⁰⁹ The arbitrator also stated that even if one had admitted that circumstances amounted to force majeure, it would not be possible to exclude the liability since it was not proven that the state partner did every effort to make up for non-compliance as required by Article 33 of the agreement. Finally, as the liability of the state partner was uncontestable under the liability regime provided for in the agreement, the arbitrator did not find it necessary to examine whether liability would also exist according to the State Y law.²¹¹⁰

When the contract requires the obligor to notify the other party of the force majeure event, such a duty can be considered as a requirement for the force majeure excuse and the failure to perform it as agreed may preclude the obligor from successfully invoking the force majeure excuse, depending on the formulation of the force majeure clause or the extent of delay. In ICC Case No 2478, the arbitral tribunal considered the substantive delay in notifying the other party of the force majeure event prevented the non-performing party from invoking the force majeure excuse. The tribunal dealt with a claim for damages made by a French company against a Rumanian company, which had not delivered to it a certain quantity of fuel. The tribunal found that the cancellation of the export license by the Rumanian authorities constituted a case of force majeure, both on the level of the general principles of law and on the level of the force majeure clause of the contract. However, the force majeure clause required the party invoking it to inform the other party without delay, in writing, of the occurrence of the event of force majeure and of the consequences which it intended to draw from it. As the Rumanian authorities' decision was only made known to the other party, through the intermediary of the ICC Court of Arbitration, the arbitrators held that the respondent lost the possibility of taking advantage of force majeure.²¹¹¹

In ICC Case No 4237, the failure to notify the other party of the force majeure event was instrumental in the tribunal's rejection of the force majeure excuse. The case concerned a sales contract concluded on August 15, 1979 between a Syrian buyer and a Ghanaian supplier. The contract stipulated payment by confirmed and irrevocable letter of credit. The contract contained a force majeure clause, which provided that "(a) In the event of confronting force majeure of any nature, the Suppliers shall undertake to advise buyers thereof and immediately after it discontinues. (b) Fluctuation of currency and rise in prices shall not be considered as force majeure events."²¹¹² On November 26, 1979, two letters of credit in favor of the supplier were confirmed. However, the supplier was not able to ship the goods according to the shipment schedule. The buyer reminded the supplier several times of the shipment schedule and the contractual delay penalties, yet extended the shipment period and the validity of the

²¹⁰⁹ Ibid.

²¹¹⁰ Ibid., at 92

²¹¹¹ ICC Award in Case No. 2478, 1974, Yearbook Commercial Arbitration, 3 (1978), at 222

²¹¹² ICC Award in Case No. 4237, February 17, 1984, Yearbook Commercial Arbitration, 10 (1985), at 53

letters of credit until May 31, 1980. On May 7, 1980, the supplier proposed a price increase of 40% to recover their losses caused by “the increase of oil price”. During a meeting between both parties on July 28-30, 1980, it became apparent that this price increase was unacceptable to the buyer and the supplier wished to abolish the contract and relied on force majeure.

The arbitrator rejected the supplier’s argument that they were prevented from performing under the contract by force majeure. The arbitrator noted that there was no specific mention of force majeure in any telex from the supplier to the buyer until the date until which the letters of credit were extended, and the first time when force majeure had been invoked by the supplier was during the discussions at the end of July 1980.²¹¹³ The arbitrator stated that “[the supplier] have in any case failed to inform [the buyer] in a proper and timely manner about the alleged events of force majeure. Rather, what becomes clear from the record, [the supplier was] in principle able to deliver but wished to have higher prices.”²¹¹⁴ The arbitrator concluded that “[the supplier] assert that the alleged events in Ghana were internationally known, and should certainly have been known to [the buyer] which are well-informed State organization. Leaving aside that such knowledge cannot substitute the requirement of a notice of an event of force majeure under Clause 15 (a) of the Contract, if every governmental reshuffle and accompanying public excitement constitutes force majeure, world trade would in modern times be bogged down to uncertainty.”²¹¹⁵

b. Effects of Force Majeure Excuse

The decision maker applying *lex mercatoria* should consider the approach of general contracting practices, which emphasizes the suspension of the performance, rather than outright termination or dissolution of the contract in the events of force majeure. As the parties often have a substantial common interest in the survival of the contract, they stipulate that the obligations affected by force majeure will initially only be suspended. This consideration should motivate the reasoning of the decision makers to extend the contract duration, when the effects of a force majeure event last for a reasonable period of time and then cease, unless the contractual clauses or the default rules chosen by the parties explicitly denies suspension in such cases. This is also considered as a general principle of law by some commentators.²¹¹⁶

In ICC Case No 1703, the dispute arose from a turn-key contract for the supply of a factory between the claimant, an enterprise controlled by its state, and the defendant, a private company specialized in the supply and the starting up of industrial equipment. Hostilities broke out in the region, which brought about perturbations in the works and in the relations between the governments of the two parties. The defendant had to stop the work because, at the beginning of the hostilities against its state, the members of the personnel of the defendant, who were of the same nationality as the defendant, were required to leave the country. After the end of hostilities, defendant refused to continue and finish the work on the grounds that its government had withdrawn the necessary export financing facilities, that it was not possible to obtain the necessary visas for its personnel and that its security could not

²¹¹³ Ibid., at 56

²¹¹⁴ Ibid., at 57

²¹¹⁵ Ibid., at 56-57

²¹¹⁶ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 831

be maintained. The arbitral tribunal stated that “The conditions in the country arising in connection with the hostilities inter alia the display of anti (the defendant’s country) reactions, presented a situation where, in view of the reasonable apprehension of threats to their own safety and that of their families, the employees could not be required to remain in the country.”²¹¹⁷ Thus, the tribunal considered that the defendant was excused from performance under the claimant’s law and the contract for the duration of the hostilities and at least for a certain period of time thereafter.

According to the tribunal, after that period, the political situation in the country did not present dangers of such kind as to prevent the continued performance of the contract. The claimant argued that if the defendant, according to the contract, had given the claimant further notice, explaining the precise problems encountered through the defendant’s government’s prohibition and the difficulties to get visas, the claimant, considering the national importance of the project, could have made it possible for the defendant to have the contract performed. The tribunal noted that there was no evidence indicating that the defendant made any serious efforts to get visas, while some evidence indicated that, had such efforts been made, visas would have been obtained. According to the tribunal, “even apart from the question relating to visas other alternatives in order to overcome the difficulties in performing the contract, such as e.g. the assembling of a start-up team consisting of non-country of the defendant citizens, ought to have been explored by the defendant.” With regard to the financing facilities, the tribunal accepted that further financing through the defendant’s government agency became impossible, but noted that an arrangement of other means of financing than through the agency would have been a possibility open to the parties and would not have adversely affected the defendant. The tribunal stated that “The defendant, however, has not shown that, in accordance with the provisions of ... the Contract, it has informed the claimant of the defendant’s willingness to continue performance of the Contract once the claimant had made available new means of financing the remaining – proportionally minor – payments under the Contract.” Thus, the tribunal considered that the defendant failed to pursue a course which could have preserved the essence of the contract.²¹¹⁸ The tribunal rejected the plea of force majeure, since the effects of the force majeure event on the defendant’s performance of its obligations became reasonably avoidable after a certain period of time.

Where the parties have not clearly agreed so, the decision, which declares that the performance of the contract is suspended for the duration of the force majeure event, is a form of supplementation of the contract with an implied term, which requires the parties to continue performance upon the cessation of a force majeure condition. Thus, such a decision may give rise to residual questions as to the duration of the contract and costs of performance. In this respect, the decision maker should seek guidance in the interpretation of the contract and the underlying bargain and refrain from a decision of suspension if such an interpretation requires the dissolution of the contract. This is particularly the case where a force majeure event extends over a substantial amount of time and become permanent in view of its consequences with regard to the performance of certain obligations as agreed under the contract. Moreover, the suspension of the contract due to the force majeure event may not be appropriate in cases where the parties cannot reasonably foresee for how long the effects of the force majeure event would last or whether those effects would ever cease, given that the parties may conclude with third persons similar contracts that have not been affected by the relevant event.

²¹¹⁷ ICC Award in Case No. 1703, Yearbook Commercial Arbitration, (1976), at 131

²¹¹⁸ Ibid., at 132

In the Alsing award, Greece was alleged to have breached a long-term contract with Alsing for the supply of matches for twenty years. Alsing argued that the contract should be extended for six years, corresponding to those of the World War II and thereafter (1940-46), when deliveries were not possible. The Umpire noted that, under the contract, Greece was not bound to receive a definite quantity of matches, and Greece's obligation to obtain merchandise depended on its need for it, which may diminish or disappear as a result of circumstances. Although Greece did not cease to require matches during the years 1940-46, it was impossible for it to be supplied by Alsing. The Umpire stated that "The State's obligation to fulfil the contract was abolished for the period under consideration by reason of the impossibility of taking delivery ('impossibilium nulla est obligatio'), and [Greece] legitimately met its match requirements by going to other suppliers. No more than if the requirements as such had entirely or partly disappeared, can the plaintiff constrain the State to buy later the quantities of matches which it has already procured elsewhere." The Umpire explained that "even in a sales contract providing for successive deliveries of a certain quantity of goods, the impossibility of making one or more deliveries frees the obligor from these obligations, without his being bound later to deliver or to take delivery of the quantities in question. Each delivery in a contract of this kind constitutes the fulfilling of a separate obligation which may be annulled for reasons peculiar to it. ... No doubt, in order to justify the impossibility of fulfilling one of the successive obligations, the existence of a temporary obstacle of which the removal seems possible is not sufficient; the fulfilment is in that case only delayed. But fulfilment is considered impossible when it is not possible to foresee the duration of the existence of this obstacle. . . . Such was certainly the case with the obstacles which the naval war, the occupation of Greece and the postwar difficulties placed in the way of fulfilling the supply contract. This being the case, Alsing's claims referring to acceptance and payment for periodic deliveries during the years 1940-46 were annulled; they did not again assume validity from the fact that the obligations as such subsequently became possible of fulfilment"²¹¹⁹

The Umpire found support for this reasoning in the contractual clause, which provided that "cases of 'force majeure' release the company from all responsibility." According to the Umpire, "Nothing in the text of the contract can lead one to suppose that in addition to being released from its obligations, Alsing should receive as 'compensation' the right to effect later the deliveries made impossible by the events of the war and its aftermath." The Umpire considered the supply contract as a contract of successive or continuous execution, but subject to an expiry period. In his view, the obligations which establish a lasting relationship between the parties cease on expiry of the agreed period, without account having to be taken of the fact that during certain periods fulfillment of the obligations was impossible for one or other of the parties. The Umpire stated that "the duration of the contract must be thought of as a 'tempus continuum' and not as a 'tempus utile,' in which the contract would be extended by the total amount of the periods during which the carrying out of the contracts encounters obstacles. The 'tempus utile' clause is exceptional and should follow clearly from the contract; it is inconceivable in a contract of long duration." According to the Umpire "These principles are those of common law springing from Roman law . . . Greek jurisprudence is based on these grounds..."²¹²⁰

²¹¹⁹ Schwebel, Stephen M., *The Alsing Case*, *International and Comparative Law Quarterly*, 8 (1959), at 340

²¹²⁰ *Ibid*, at 341

The force majeure issues were commonly relevant to the disputes resolved by the Iran United States Claims Tribunal as a result of the circumstances surrounding Iranian Revolution, which ensured that the doctrine of force majeure would play a significant role in the Tribunal's decisions. In a number of awards, the Tribunal stated that "[b]y December 1978, strikes, riots and other civil strife in the course of the Islamic Revolution had created classic force majeure conditions at least in Iran's major cities. By 'force majeure' we mean social and economic forces beyond the power of the state to control through the exercise of due diligence."²¹²¹ The Tribunal recognized force majeure as a general principle of law and, determined the legal consequences of force majeure without focusing on a particular national law.²¹²²

In the case of *Anaconda-Iran, Inc. v. Iran*, the Tribunal was asked to determine whether either party or both of them justifiably could invoke force majeure as an excuse for non-performance of contractual obligations and to determine the cause of termination of the agreement.²¹²³ The dispute concerned a "Technical Assistance Agreement" ("TAA"), according to which, the claimant Anaconda was to provide the defendant National Iranian Copper Industries Company with certain technical assistance in connection with the development, construction and operation of an opencast copper mine and related plant and smelter in Iran. In consideration, the claimant was entitled to reimbursement of expenses incurred and payment of a certain fee. Both parties performed under the TAA at least up until 1978. By 5 January 1979, social and political unrest in Iran had increased to such a degree that the claimant felt compelled to exercise its right, pursuant to Section 2.06 of the TAA, to invoke force majeure as an excuse for non-performance of its obligations, and proceeded to withdraw its personnel from Iran. Section 2.06 provided that: "[The claimant] shall have no responsibility to the extent and for the period that its obligations under this Agreement are affected by a force majeure incident, including without limitation, floods, tempest, earthquakes, sabotage, uprising, civil war, acts of government, epidemics and incidents beyond the control of [the claimant]. If prior to the Date of Operation any force majeure incident prevents the continuation of the Project and such incident continues in effect for a period of six months, then [the defendant] alone may upon notice to [the claimant] terminate this Agreement."²¹²⁴ The defendant contended that the withdrawal of the claimant's personnel from Iran constituted a breach of the TAA as the defendant rejected the invocation of force majeure, and the conditions in Iran, at the time, did not constitute force majeure. On May 31, 1979, the claimant terminated the TAA for the reason that the defendant failed to pay in accordance with the agreement amounts.²¹²⁵ The claimant claimed entitlement to the equivalent of 18 months Technical Service Fee, as provided for in the TAA ("Termination Damage"), in addition to the amounts due and its "Termination Costs", as provided by the

²¹²¹ *Gould Marketing, Inc. v. Ministry of National Defense of Iran*, Award No. ITL 24-49-2 at 11 (27 July 1983), 3 IRAN-U.S. C.T.R., at 152-153, cited by *International Technical Products Corporation v. Government of the Islamic Republic of Iran*, Award No. 186-302-3 at 214 (19 August 1985), 9 IRAN-U.S. C.T.R., at 23 and *Anaconda Iran Ltd. v. Iran*, Award No. ITL 65-167-3, (10 December 1986) 13 IRAN-U.S. C.T.R., at 212

²¹²² Crook, John R., *Applicable Law in International Commercial Arbitration: The Iran-US-Claims Tribunal Experience*, *American Journal of International Law*, 83 (1989), at 293 *Anaconda-Iran, Inc. v. Iran*, 13 Iran-U.S. C.T.R. 199, (1986 IV), at 211: ("Under a variety of names, most, if not all, legal systems recognize force majeure as an excuse for contractual non-performance. Force majeure therefore can be considered a general principle of law [T]he right to invoke force majeure does not depend on, or arise out of, an express contractual provision").

²¹²³ *Iran-US Claims Tribunal, Anaconda Iran Ltd. v. Iran*, 13 IRAN-U.S. C.T.R. 1986, at 200

²¹²⁴ *Ibid.*, at 204

²¹²⁵ *Ibid.*, at 207

TAA. The defendant disputed the claimant's alleged entitlement to payment for Termination Costs and Termination Damage as well as the claimed interest thereon, on the ground that the claimant had ceased to perform its obligations as of 5 January 1979 and that it did not resume performance prior to the termination of the Agreement.²¹²⁶

The Tribunal stated in general terms that “force majeure is an excuse for non-performance of a contractual obligation which depends on the facts and circumstances. When there is a situation of force majeure, the performance of contractual obligations will, partially or totally, be suspended. Force majeure also can have the effect of terminating a contract if force majeure renders performance of the contract impossible in a definitive way or for a prolonged period of time. As force majeure arises out of and depends on factual circumstances, it will affect a contract as soon as the circumstances emerge which create the obstacle to performance. The actual effect force majeure will have on the contract depends, however, on the extent to which these circumstances, practically and objectively, render performance impossible. Consequently, the existence of force majeure does not depend on, or arise out of, an agreement between the parties as to the existence of such circumstances. Nor is the application of force majeure dependent on any special formal requirements, unless the contract in question so provides. Under a variety of names most, if not all, legal systems recognize force majeure as an excuse for contractual non-performance. Force majeure therefore can be considered a general principle of law. It follows that the right to invoke force majeure does not depend on, or arise out of, an express contractual provision. The parties to a contract may, however, agree that force majeure will have certain specific consequences for their contractual performance or with respect to termination of the contract. They also can decide that their contractual obligations, or some of them, will not be affected by force majeure. It is clear, however, that a limitation on the right to invoke force majeure as an excuse for non-performance cannot be presumed, but requires instead an express contractual provision to that effect.”²¹²⁷

In accordance with its established practice, the Tribunal found that the claimant was excused from performance under the TAA from the time of departure of the claimant's personnel in January 1979 up until 15 February 1979 due to force majeure. The Tribunal noted that after 15 February 1979 the conditions in Iran had gradually evolved towards more normal conditions, but under the circumstances of the case, the Tribunal found that at least up until 31 May 1979 the conditions in Iran were such as to justify continued non-performance by the claimant to the extent that contractual performance required the presence in Iran of United States personnel.²¹²⁸ In that context, the Tribunal examined whether, contractually or otherwise, the defendant remained liable to the claimant when the claimant's non-performance was excused due to force majeure. The Tribunal noted that the TAA explicitly only provided for the effects that a force majeure situation will have on the claimant's obligations and was silent as to the effect of such a situation on the defendant's obligations. However, given that Section 2.06 authorized the defendant “alone” to terminate the TAA after six months of continuing force majeure conditions, the tribunal considered that this right, conferred solely on the defendant, was only explained if the defendant's obligation to make contractual payments was not conditioned on the claimant's actual performance in case of force majeure. The Tribunal noted that although such an obligation, *prima facie*, may appear unfavorable to

²¹²⁶ Ibid., at 209

²¹²⁷ Ibid., at 211-212

²¹²⁸ Ibid., at 213

the defendant, the defendant remained entitled to require the claimant's unconditional continued performance immediately upon the expiry of the period of force majeure and that was not unreasonable to assume that such entitlement constituted valuable consideration for the defendant in view of the scope and magnitude of the project in question. According to the Tribunal, it was in the interest of the defendant that the claimant remained obligated to incur the costs related to retention of their personnel in view of an assumed resumption of performance of the TAA. In conclusion, the Tribunal rejected the defendant's contention that the claimant's non-performance justified the defendant's non-payment of the Technical Service Fee, employee salaries and fringe benefits for the period from 1 February 1979 until the date of termination of the TAA.²¹²⁹

The Tribunal noted that the claimant notified the defendant on 22 March 1979 of its intention to terminate the TAA, at which time, as the Tribunal found, the claimant was excused from performance due to force majeure. Under the TAA, the claimant had the express right to terminate the TAA for failure by the defendant to pay "any amount" due, which was deemed to be a material breach by the TAA, and this right was neither explicitly, nor, in the view of the Tribunal, impliedly conditioned an actual performance by the claimant. The tribunal also noted that the defendant did not invoke force majeure as an excuse for its own non-performance, but maintained the position that force majeure conditions were not prevailing in Iran at the relevant time. Thus, the Tribunal was not asked to decide if the circumstances existing at the relevant time were such as to justify a suspension of defendant's payment obligations pursuant to the TAA. The Tribunal, therefore, did not reach the issue whether such a determination could affect its findings. The Tribunal concluded that the claimant was entitled to terminate the TAA on 31 May 1979 due to the defendant's breach of the TAA, and awarded substantial part of its claimed amount for the defendant's breach of the TAA.²¹³⁰

Thus, according to the Tribunal, when there is a situation of force majeure, the performance of contractual obligations will, in the first instance, be suspended partially or totally. The question of which contractual obligations are suspended by the reason of force majeure is determined by the Tribunal on the basis of the interpretation of the contract and in accordance with the risk allocation as agreed by the parties. A force majeure event, which is permanent or extends over a substantial amount of time, leads to the termination of a contract by reason of frustration or impossibility of performance, even if the parties did not invoke force majeure, or the contract does not provide for such termination.²¹³¹

In *Mobil Oil Iran, Inc. v. Iran*, the Tribunal considered that the relevant agreement was suspended but not frustrated or terminated by the events of force majeure. The dispute concerned a long-term Sale and Purchase Agreement (SPA) between Iran and a group of major oil companies collectively known as the "Consortium". In December 1978-January 1979, as a consequence of the revolutionary events that were taking place in Iran, the production of oil was reduced substantially and eventually interrupted. On 10 March 1979 the defendant sent the Consortium a letter stating that the SPA "proved to be inoperative, soon after the Effective Date due to the fact that the latter companies failed to comply with certain essential provisions of the Agreement" and listing a series of principles upon which the future relationship should be based. On 23 March 1979 the Consortium, while reserving all their

²¹²⁹ Ibid., at 215

²¹³⁰ Ibid., at 216

²¹³¹ Brunetti, Maurizio, *The Lex Mercatoria in Practice: The Experience of the Iran- United States Claims Tribunal*, Arbitration International, 18 (2002), at 364

rights, proposed a meeting for the purpose of reaching an agreement on the termination of the SPA. Negotiations were initiated but failed to produce any agreement before November 1979, when the rupture of all relations between Iran and the United States caused these negotiations to end.²¹³² Article 27 of the SPA envisioned force majeure as an excuse for failure by a party to comply with the terms of the agreement, but only as causing a suspension of certain provisions of the agreement. The Tribunal stated that “This is in line with the most common practice in contract law. Usually, force majeure conditions will have the effect of terminating a contract only if they make performance definitively impossible or impossible for a long period of time. It also is admitted generally that force majeure, as a cause of full or partial suspension or termination of a contract, is a general principle of law which applies even when the contract is silent.” Thus, although Article 27 did not so provide, the Tribunal held that it was no obstacle to a finding that the agreement was terminated by force majeure if the circumstances warrant such a finding. In the circumstances of the case, the Tribunal did not find that on 10 March 1979 the situation was such that the agreement could be considered as frustrated or terminated for cause of force majeure because a new revolutionary Islamic Government had already been established, and, thus, the conditions could be expected to progressively return to normal.²¹³³

In another case, *Sylvania Technical Systems, Inc. v. Iran*, which concerned a contract to train Iranian Air Force personnel to operate and maintain an electronic intelligence gathering system, Sylvania alleged that the Iranian Government breached and repudiated the contract in January and February 1979.²¹³⁴ The Tribunal emphasized that force majeure defenses “must always be analyzed in the context of the circumstances causing force majeure, taking into

²¹³² *Mobil Oil Iran, Inc. v. Iran*, 16 IRAN-U.S. C.T.R., at 10

²¹³³ *Ibid.*, at 38-39 paras. 116-117; However, the Tribunal noted that it would be erroneous to pretend that the conditions in Iran already had returned to normal by 10 March 1979. According to the Tribunal, the dramatic political changes brought about in Iran by the success of the Islamic Revolution and the decision of the Islamic Government to follow a policy radically different from that of the previous Government in the oil industry could not be without consequences to the contractual relationship between Iran and the Consortium, even if the changes of such a character and magnitude could not have had any effect on the validity of the agreement without materializing in specific measures. The Tribunal stated that “A close scrutiny of the exchange of letters of 10 and 23 March 1979, as well as of the conduct of the Parties prior to and after this exchange, demonstrates that the Parties agreed at this time not to revive the Agreement, then suspended by force majeure. This agreement, however, was not unconditional. Both parties recognized that a reconciliation of interest was to take place between them, and that this reconciliation, as well as the other issues arising from the termination of the Agreement, was to be the object of subsequent negotiations, as spelled out in the 23 March letter. Such negotiations eventually took place and, undoubtedly, would have resulted in compensation for the loss sustained by the Consortium alluded to in the same letter. Any other outcome of the negotiation, in the absence of other counterparts acceptable to the Companies, would have amounted to an unjust enrichment of Iran and [National Iranian Oil Company] and an unjust loss for the Companies.” The Tribunal held that the fact that the negotiations did not succeed before November 1979 and were interrupted by the events which took place during that month did not relieve the defendants from their obligation to compensate the loss sustained by the Consortium. *Ibid.*, at 39-42 paras. 119-127; Thus, although the tribunal rejected the assertions that the SPA was terminated by way of frustration, it found that, after the occurrence of force majeure events, the parties agreed to terminate the agreement with the understanding that the legal and financial consequences of such a termination, including the compensation to be paid by the parties, would be determined through negotiations. In order to ascertain the compensation to be paid by one party to the other, the Tribunal decided to determine what the parties could legitimately have expected from negotiations conducted in good faith on the basis of the exchange of letters during March 1979, which established an agreement between the parties, by interpreting the SPA, not only pursuant to its initial terms, but also as to the manner in which it was performed and de facto or de jure amended during its life, up to the time it was suspended by force majeure. *Ibid.*, at para. 161

²¹³⁴ *Iran-U.S. Claims Tribunal, Sylvania Technical Systems, Inc. v. Islamic Republic of Iran*, 8 IRAN-U.S. C.T.R., at 299

account the particular part affected by those circumstances and the specific obligations that party is prevented from performing.”²¹³⁵ The Tribunal pointed out that, “[f]orce majeure being an exception to the obligation to perform, a party that invokes it has the burden of proving that conditions of force majeure existed with regard to its various contractual obligations.”²¹³⁶ The Tribunal held that force majeure conditions existing in Iran from late December 1978 until 15 February 1979, suspended both parties' performance under the contract, but rejected for lack of proof the defendant's contention that force majeure conditions extended beyond 15 February 1979 so as to prevent the defendant from performing its obligations. The Tribunal noted that the Iranian government had terminated the contract as a result of a “deliberate policy decision not to continue with American contractors in a project that related to secret military intelligence operations” and that such a decision had been taken in view of an historic development, and did not convey that performance by the defendant was prevented by the events beyond its control.²¹³⁷ Thus, the Tribunal applied the provisions of the contract, which reserved to the Iranian government the right to make such policy decision and to decide to terminate the contract, while imposing on the government certain financial obligations.

In other cases, the Iran United States Claims Tribunal held that the relevant agreements were terminated due to the events of force majeure and went on to determine the consequences of termination in relation to the questions of restitution. In many cases the contracts contained no provisions regulating the consequences of force majeure, and the Tribunal was left with wide latitude in determining the way in which the winding up between the parties was to be carried out.²¹³⁸ In *Queens Office Tower Associates v. Iran National Airlines Corp.*, the Tribunal set the precedent, with regard to the rights and the liabilities of the parties in cases of the premature termination of the contract due to force majeure, that “The governing rule is that the loss must “lie where it falls”. The apportionment of the loss is subject generally to the Tribunal's equitable a discretion, using the contract as a framework and reference point.”²¹³⁹

In *Gould Marketing, Inc. v. Iranian Ministry of National Defense*, the dispute arose from a supply contract under which the claimant was to provide certain equipment and services to the Ministry and to provide a field service representative (“FSR”) in order both to train Iranian nationals in the maintenance of the equipments and to carry out as many on-the-spot repairs as it could. The services were to be rendered over a ten year period between 1976 and 1986, but were in fact rendered for only three years. The claimant withdrew its FSR in December 1978 due to the existence of unsafe conditions, and the defendant stopped its performance of the obligations as to the payment schedule in June 1979. The tribunal considered that, the claimant's inability to supply services due to the social upheaval in Iran justified non-performance by both parties: the claimant was excused from maintaining its FSR in Iran, and the defendant's failure to pay the June 1979 milestone was similarly excused. Since a suspension of both parties' performance obligations could not continue indefinitely without having some effect on the viability of the contract, the Tribunal held that “the continued

²¹³⁵ Ibid., at 309

²¹³⁶ Ibid., at 312

²¹³⁷ Ibid.

²¹³⁸ Brunetti, Maurizio, *The Lex Mercatoria in Practice: The Experience of the Iran- United States Claims Tribunal*, *Arbitration International*, 18 (2002), at 366

²¹³⁹ Iran-U.S. Claims Tribunal, *Queens Office Tower Associates v. Iran National Airlines Corp.*, 2 IRAN-U.S. C.T.R., at 254

existence of force majeure conditions had by mid-1979 ripened into a termination of the ... contract. Performance had become essentially impossible.”²¹⁴⁰

Given that the contract was governed by the law of California according to the choice of law clause, the Tribunal stated that “Under American law, as under English law since 1943, the general principle applied to equitably allocate such consequences of frustration of contract is that amounts due under the contract are to be proportioned to the extent the contract was performed. If no payment has been made, the Party which has performed is entitled to receive payment to the extent of that performance. If payment has been made, the Party which received such payment is entitled to retain that amount of money proportionate to its performance and must return any money in excess of that amount. In applying this general principle, the Tribunal should avoid unduly burdening either party with the hardships arising from the termination. Regardless of how difficult it might be for the Tribunal, as for any Court, to equitably allocate these burdens and how imperfect might be the justice reached, such difficulty and such imperfection should not be a reason for denying any relief.”²¹⁴¹ It concluded that “the measure of the value of that performance can be found by dividing the relevant contract price by ten and then multiplying the resulting figure by three”.²¹⁴² As a result of the Tribunal’s calculations, the claimant was ordered to repay the respondent the excess monies it had received pursuant to the schedule of payments provided for by the contract.

Where the contract was terminated as a result of force majeure event, the Iran US Claims Tribunal declined to award any costs or fees incurred after the date of termination or any lost profits as those would amount to awarding damages. In *International Schools Services, Inc. v. National Iranian Copper Industries Co.*, which concerned a contract for the operation of an American elementary school for the dependent children of the expatriate workers of National Iranian Copper Industries Co., the claimant closed the school and ceased its performance under the contract in January 1979 due to the political unrest in Iran. It claimed for the amount of unpaid invoices for goods sold and services rendered as well as lost profits in the amount it would have earned had it not been forced to leave Iran prior to the expiration date of the contract. The Tribunal found that the force majeure situation amounted to a frustration of the contract in early 1979. Because there was little proof as to the specific date when the contract came to an end, and for the purposes of convenience, the tribunal determined that such date was 1 January 1979. Thus, the Tribunal held that as of 1 January 1979, the parties were excused from further performance under the contract and discharged from their duty to perform contractual obligations not yet due. The Tribunal noted that the contract itself and Article 229 of the Iranian Civil Code incorporated this principle, and concluded that “In apportioning the loss in this case the Tribunal finds that, applying the principles set out above, the Claimant should be reimbursed for the costs and fees that it incurred prior to 1 January 1979, but should not be reimbursed for any costs or fees incurred after that date, nor should it be compensated for any ‘lost profits’”.²¹⁴³

²¹⁴⁰ Iran-U.S. Claims Tribunal, *Gould Marketing, Inc. v. Ministry of National Defence*, (Interlocutory Award), 3 IRAN-U.S. C.T.R., at 154

²¹⁴¹ *Gould Marketing, Inc. v. Ministry of National Defence*, (Final Award), 6 IRAN-U.S. C.T.R., at 274; This passage was cited by *William J. Levitt v. Islamic Republic of Iran*, Award No. 520-210-3, 29 August 1991, 27 IRAN-U.S. C.T.R., at 168

²¹⁴² *Gould Marketing, Inc. v. Ministry of National Defence*, (Final Award), 6 IRAN-U.S. C.T.R., at 279

²¹⁴³ Iran US Claims Tribunal Award in Case No. 111 (194-111-1), October 10, 1985, *International Schools Services, Inc. v. National Iranian Copper Industries Company*, Yearbook Commercial Arbitration, (1987), at

In *Westinghouse Electric Corp. v. Islamic Republic of Iran Air Force*, which concerned a project for the establishment of maintenance capability for the Iranian Air Force's electronic equipment, the Tribunal held that the agreement was terminated due to the events of force majeure and rejected the claims for specific performance. The Tribunal noted that the first legal consequence of such a termination is that, as of the date of termination, the parties are excused from further performance and discharged from their duty to perform contractual obligations not yet due.²¹⁴⁴ The Tribunal stated that the governing rule for the determination of the rights and liabilities of the parties in light of the termination of the contracts is that “the loss must lie where it falls” and the Tribunal practice in these situations has been to allocate equitably any loss between the parties in proportion to the extent the contract was performed by the date of termination. The Tribunal, referring to, among others, the cases of *Gould and International Schools Services*, stated that “it will determine the extent to which Westinghouse performed its obligations under each ... contract at issue until such performance was made impossible, and whether, based on such performance, Westinghouse is entitled to receive further payments or, on the contrary must return to the Air Force part of the payments it received. In accordance with Tribunal practice in frustration cases, Westinghouse should not be reimbursed for any costs or fees incurred after the date the contracts came to an end, nor should it be compensated for lost profits... Moreover, by finding that the ... contracts terminated by the end of December 1979, the Tribunal has necessarily rejected all of the Air Force's counterclaims for specific performance.”²¹⁴⁵

Thus, in the Tribunal's practice, the governing rule in force majeure cases was that the parties' losses must lie where they fall, excluding the claims for specific performance and damages, subject to the Tribunal's discretion to allocate equitably any such losses in proportion to the extent the contract was performed by the date of termination.²¹⁴⁶ In the case *Unidyne Corp. v. Islamic Republic of Iran* concerning a contract under which Unidyne was to design and maintain a “Maintenance and Material Management” (or 3M) program to facilitate timely repairs and maintenance of the Iranian Navy's fleet, the parties differed fundamentally on the causes of the non-completion of the contract. While the defendant contended that the claimant unlawfully failed to finish its work, the claimant alleged that the defendant's actions prevented it from doing so.²¹⁴⁷ As to the unfinished work, the claimant maintained that this was due to force majeure circumstances prevailing in Iran at the time. The claimant stated that because the Iranian revolution was the cause of its inability to continue performance, it was relieved of any liability by the force majeure clause of the contract. Moreover, the claimant considered that it should be paid compensation for the losses that it incurred as a result of the

333; Similarly, in *Linen, Fortinberry and Associates v. Iran*, considering that the purpose of a contract pursuant to which an American public relations firm was to promote the public image in the United States of the Pahlavi dynasty's Iran was frustrated by the success of the Islamic Revolution, the Tribunal held that the contract should be considered to have terminated on or about 31 January 1979, which was the mid way between the departure of the Shah from Iran and the installation of the Islamic Republic. Thus, the tribunal decided that the American firm was entitled to payment until that date. Iran US Claims Tribunal Award in Case No. 10513 (372-10513-2), June 28, 1988, *Linen, Fortinberry and Associates v. Iran*, *Yearbook Commercial Arbitration* (1989), at 459

²¹⁴⁴ *Westinghouse Electric Corp. v. Islamic Republic of Iran Air Force*, 33 IRAN-U.S. C.T.R., at 80 para. 62

²¹⁴⁵ *Ibid.*, at 81 para. 64

²¹⁴⁶ Brunetti, Maurizio, *The Lex Mercatoria in Practice: The Experience of the Iran- United States Claims Tribunal*, *Arbitration International*, 18 (2002), at 367

²¹⁴⁷ Iran US Claims Tribunal Award in Case No. 368 (551-368-3), November 10, 1993, *Unidyne Corporation v. the Islamic Republic of Iran*, *Yearbook Commercial Arbitration* (1995), at 556

Revolution because the event “was of [the defendant’s] own making.” The respondent denied the existence of force majeure conditions as alleged by the claimant.

The tribunal found that the events occurred in November 1979, namely the seizure of the United States Embassy in Tehran, and ensuing deterioration of the relations between the United States and Iran, profoundly disturbed the performance of the contract, and the contract ultimately ground to a halt. Thus, in the tribunal’s view, the situation in Iran after the seizure of the Embassy amounted to force majeure for the claimant preventing it completing the work and ultimately leading to termination of the contract.²¹⁴⁸ As to the effect of such termination, the Tribunal noted that the force majeure clause in the contract did not explicitly allocate between the parties the effects of a termination of the agreement for that reason.²¹⁴⁹ The Tribunal found that the claimant should not be held liable for the non-completion of the contract and dismissed the counterclaims of the defendant for non-completion of the work. In light of the Tribunal’s prior finding that the social and economic forces operating in Iran during the height of the Islamic Revolution were beyond the power of the state to control through the exercise of due diligence, the Tribunal did not find the defendant liable for the extra costs and expenses incurred by the claimant, which were caused by the upheaval flowing from the said forces. The tribunal also refused to award the claimant’s claim for lost profits as the contract was terminated due to force majeure.²¹⁵⁰ The claimant maintained that it was not paid for all the work it had performed, but the defendant replied that as the contract was never completed, it was left with nothing more than reams of incomplete and useless papers. The Tribunal stated that “While it is indeed debatable whether the Respondent was able to implement and utilize fully the 3M system without further expertise of the Claimant and therefore whether the Respondent was able to benefit in every respect from the work accomplished, the Tribunal’s approach has been to hold a party liable to pay for work that was carried out prior to the occurrence of a force majeure event, although the contract was never fully performed.”²¹⁵¹ Thus, the Tribunal determined that the claimant was entitled to the balance in question plus interest in accordance with its precedents, according to which the governing rule as to the rights and liabilities of the parties in these circumstances is that “the loss must lie where it falls”, and “the apportionment of the loss is subject generally to the Tribunal’s equitable discretion, using the contract as a framework and reference point.”²¹⁵²

The approach of the Iran United States Claims Tribunal to the determination of the consequences of force majeure represents the abstract reasoning of a decision maker, who applies *lex mercatoria* as the law of principled adjudication of contractual disputes. It is argued that where the loss cannot be honestly attributed to the conduct of either party, the arbitrators on occasion, whatever the legal position, require the parties to share the loss and, thus, treat the frustration of the contract as a common hazard to be faced and the ensuing loss a common loss to be borne by both parties jointly rather than alone.²¹⁵³ Thus, the flexibility to

²¹⁴⁸ Ibid., at 559

²¹⁴⁹ Ibid., at 560

²¹⁵⁰ Ibid., at 561

²¹⁵¹ Ibid., at 561-562

²¹⁵² *International Schools Services, Inc. v. National Iranian Copper Industries Co.*, Award No. 194-111-1, (10 October 1985), 9 IRAN-U.S. C.T.R., at 197 (citing *Queens Office Tower Associates v. Iran National Airlines Corp.*, Award No. 37-172-1, (15 April 1983), 2 IRAN-U.S. C.T.R., at 254); *William J. Levitt v. Islamic Republic of Iran*, Award No. 520-210-3, 29 August 1991, 27 IRAN-U.S. C.T.R., paras. 74-75

²¹⁵³ Lew, Julian D. M., *Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards*, Oceana, 1978, at 509-510

apportion loss in consequence of force majeure excuse in the context of international arbitration may be perceived as an instance of the impression of “splitting the difference” by the arbitral tribunals between the parties. Indeed, the ad hoc arbitral tribunal in *Chevron Corporation & Texaco Petroleum Corporation v. Ecuador* stated in general terms that, “the doctrine of force majeure, like the doctrine of hardship and other related concepts, is designed to ‘distribute between the parties in a just and equitable manner the losses and gains resulting from’ an unforeseeable event.” On the basis of this premise, the tribunal did not accept an interpretation that would mean that any negative effect of a force majeure situation would exclusively have to be borne by one party and in no way by the other party, in the absence of a support provided by the contract between the parties or the applicable national law for such an unusual interpretation.²¹⁵⁴ Although the necessity of this flexibility is commonly explained on the basis of the concerns for justice and equity, the resulting discretion should not be motivated by an exercise of splitting the difference just to satisfy both parties, but it should relate to the decision makers’ concern for reflecting accurately the reasonable expectations of the parties in such a residual allocation.

It should be underlined that, in these cases due to the basic requirements of the force majeure excuse, there are no indications of the explicit or tacit risk allocation agreed between the parties as to the distribution of losses and gains resulting from the force majeure event. Thus, the decision maker is required to take into account the underlying bargain and to discover the established rules in a particular case, which should be employed in the allocational ex post decision, since the knowledge of such rules is considered as part of the contracting parties’ cost of enabling the correspondence of the expectations in the order of international commerce. In force majeure cases, the decision maker will, in most cases, discover, either through abstractions from the general contracting practices and the flexible approach of national legal systems or through the established rules of conflict, such established rules that allow the restitutionary remedies and, at the same time, enable the decision maker to make monetary adjustments rather than restitution in kind, when the latter is not possible or appropriate. Thus, the allocational decision as a consequence of force majeure excuse is almost necessarily an instance of the decision maker’s exercise of equity *infra legem* and arises from the established rules in the particular case.

3. Concluding Remarks

The decision maker applying *lex mercatoria* should approach the issues of force majeure as a matter of risk allocation between the parties. The party invoking the excuse should prove that two basic requirements of the force majeure excuse have been fulfilled in the particular case, unless otherwise specifically provided by the parties in the terms of the contract or by the applicable default rules. These requirements essentially determine whether or not there is a gap in the risk allocation under a particular bargain. If the obligor is prevented from performing by an event whose occurrence, according to the intentions or expectations of the parties, is at neither party’s risk, then there is a gap in the risk allocation, and an exception will be made for its liability for non-performance. The first basic requirement of force majeure is that the event must prevent the obligor from performing any of its obligations in accordance with the underlying bargain. This requirement will usually depend on the existence of a legal, factual or physical impossibility in an objective sense. However, the subjective impossibility may also satisfy this basic requirement where the contract strictly

²¹⁵⁴ Ad hoc Arbitration, The Hague, March 30, 2010, *Chevron Corporation & Texaco Petroleum Corporation v. Ecuador*, available at <http://www.unilex.info/case.cfm?id=1534>, para. 489

requires the obligor to perform its obligations personally or through its own organization and the supervening event renders such performance impossible. Economic impossibility or impracticability may also excuse the non-performance of the contractual obligations on the basis of the articulated rules or the applicable national law, which is considered as indicating the reasonable expectations of the parties, pursuant to the established rules of conflict.

The second basic requirement of the force majeure excuse is that the effect of the alleged event of force majeure on the contractual obligations must be outside of the control of the obligor. This requirement implies that the event must be both unforeseeable and unavoidable for the obligor. The determination of the existence of the unforeseeability and unavoidability depends on the contract and the presumptions about the parties' competences, which will be determined on the basis of the test of reasonable persons of the same kind as the parties placed under the same circumstances, through the contextual approach of the decision maker. The decision maker applying *lex mercatoria* will presume that the obligor has or should have exercised the foresight expected from a reasonable person of the same kind in the same circumstances, and assumed the costs of such efforts as would be made by a reasonable person of the same kind in the same circumstances, to avoid the effect of the alleged event of force majeure on the performance of its obligations.

Thus, where the alleged event of force majeure was foreseeable at the time of contracting and the risk of the event's occurrence was not reallocated to the obligee under the contract, the obligor will be considered as having assumed the relevant risk of the event, which prevents the performance of its obligation, and he will become liable for non-performance. Even if the alleged event of force majeure was unforeseeable at the time of contracting, the obligor may not rely on the force majeure excuse where the effects of the relevant event on the contractual obligations is avoidable by means of reasonable efforts of the obligor, and the costs of such efforts are within the sphere of risk of the obligor, or assumed by the obligee under the contract. Due to the presumptions as to the obligor's competence in the order of international commerce, where the costs of such efforts merely renders the performance of the contractual obligation impractical or more onerous, the unforeseen event will not amount to a force majeure excuse. Even so, there is a link between the economic or subjective impossibility and the requirement of the unavoidability of the alleged event of force majeure in cases. This link arises from the approach of the decision maker applying *lex mercatoria* to the issues of force majeure as a matter of risk allocation and contractual interpretation. Thus, where the costs of the efforts that are required to avoid the effect of an unforeseen event on the contractual obligation are neither assumed by the obligee under the contract nor within the sphere of risk of the obligor, e.g. when the contract specifically requires the obligor to perform its obligations through its own organization, or the amount of such costs exceeds what would have been paid by a reasonable person of the same kind in the same circumstances to avoid the effects of the relevant event, the obligor may rely on the force majeure excuse, even if the relevant event does not render the performance of the obligation legally, factually or physically impossible in an objective sense under the traditional understanding of some national legal systems.

The force majeure excuse, when successfully invoked by the obligor, implies a gap in the risk allocation and requires the decision maker to allocate the relevant rights and obligations residually on the basis of an abstract reasoning that takes into account the contractual clauses and the default rules, which are applicable as a result of the parties' choice or pursuant to the established rules of conflict. The force majeure excuse initially suspends the performance of the contractual obligation, unless the contractual clauses or the default rules chosen by the

parties explicitly deny such a suspension. When available, the effects of suspension on the contract due to the temporary force majeure event, such as the extension of the period of performance, will be determined by the decision maker interpreting the contract through a contextual approach. If a force majeure event is permanent or extends over a substantial amount of time, so that it becomes permanent in view of its consequences with regard to the performance of obligations as agreed under the contract, then the contract will be terminated. In the absence of contrary indications in contractual clauses and the default rules chosen by the parties or applicable pursuant to the established rules of conflict, the termination of the contract due to a force majeure event can be considered as *lex specialis* in relation to the general right to terminate the contract for unexcused non-performance, because the obligee will not be entitled to damages for non-performance, and the termination may occur automatically. In such cases, the force majeure releases both parties from their obligations to perform and receive future performance as of the date of termination, which will be determined by the decision maker.

In principle, the termination of the contract in cases of force majeure precludes the obligee from claiming damages or specific performance and implies that “the loss lay where it fell”. This result is subject to the decision maker’s discretion to allocate any such losses in proportion to the extent the contract was performed by the date of termination, in accordance with the underlying bargain, as long as the contract or the applicable default rules do not explicitly deny a restitutionary flexibility in cases of force majeure. Accordingly, the payment obligations may be reduced proportionally, if the contract was to be performed in parts or the performance is divisible. In the cases of indivisible performance, a monetary allowance can be made to the obligor for the benefits derived by a party from anything done by the other party in the performance of the contract. Although the claims for lost profit in force majeure cases will not be awarded, the decision maker may take into account the right to claim interest for the delay in payment obligations, which arises as of the date of termination since this right is not to be characterized as a right to claim damages, but as a benefit.

Since the issue of force majeure is primarily a matter of risk allocation under *lex mercatoria*, its requirements and consequences are subject to modification by the parties’ agreement and its interpretation. Particularly, there is a remarkable similarity between the concepts of force majeure and hardship since both of them are related to the change of circumstances after the conclusion of contract. Whereas force majeure normally renders the performance of an obligation impossible, the incidence of hardship merely makes it substantially more difficult for one of the parties and upsets the balance of contract. This difference, which seems clear in theory, is rather blurred in international contracting practices, since some force majeure clauses relax the requirements justifying a force majeure excuse. It is argued that this form of drafting may reduce or even abolish the distinction that normally exists between force majeure and hardship excuses from contractual liability.²¹⁵⁵ However, the distinction still persists in practice.²¹⁵⁶ The concept of force majeure requires the temporary or permanent impossibility to perform obligations, even if the content of impossibility depends on the particular circumstances of the case, whereas the concept of hardship covers situations, which will totally modify the economical balance of the contract in the future, and raises the question of a new agreement through renegotiation and adaptation. Thus, unlike hardship, the

²¹⁵⁵ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 443

²¹⁵⁶ See, for the views of the lawyers of an oil company, Marmursztejn, Muriel, *Force Majeure Clauses of an Oil Company's Upstream Agreements: a Review*, *International Business Law Journal*, (1998), at 803-804

relevant event is not necessarily the object of a new agreement in force majeure cases, even though, in practice, the parties may formulate a force majeure clause leading to renegotiation or arbitral intervention.

iv. Hardship

The principle *pacta sunt servanda* provides that parties must adhere to the terms of the contract. In principle, modification or termination of the contract should be allowed by the mutual subsequent agreement of the parties to that effect. Such an agreement can be explicit or tacit depending on the circumstances of the case. There is also a Roman law principle, which implies that changed circumstances may affect the binding force of a contract. This principle is known under the maxim “*rebus sic stantibus*”: the contract remains binding “provided that things remain as they are”.²¹⁵⁷ Under Roman law tradition, if performance is still possible but a fundamental change in the circumstances surrounding the contract rendered performance much more onerous and the contractual liability appeared as an unfair hardship for the debtor, the debtor could invoke the principle of “*clausula rebus sic stantibus*” and assert that the contract contains an implied term (“*clausula*”) that certain important circumstances must remain unchanged (“*sic stantes*”).²¹⁵⁸ The principle of *rebus sic stantibus* mainly provides a total or partial relief to a party in case of changed circumstances. It assumes into each contract an implied term that the continuation of each party's obligations is dependent upon the continued existence of certain important facts or circumstances.²¹⁵⁹

The maxim of *rebus sic stantibus* is not universally admitted by the national legal systems. Likewise, there is no generally accepted term for describing the maxim in those national legal systems, where various default mechanisms have been introduced in order to deal with the relevant situations. Although such mechanisms vary from one national legal system to another, the underlying concept is generally described by the term “hardship” in the international contracting practices and international restatements of contract principles. The concept of hardship requires the decision maker to consider the effects on the specific contractual rights and obligations of the occurrence of a supervening event, which could not have been foreseen by the parties at the time of contracting, and because of which the performance of a contract has become much more onerous and substantially difficult.

1. Sources of Abstractions

a. National Laws

The concept of *clausula rebus sic stantibus* was not included in the French codification of private law. An undue burden on a party caused by an unforeseen event was not a reason to derogate from the principle of *pacta sunt servanda*. In the *Canal de Crappone* case from 1876, the *Cour de Cassation* stated that the rule that the contract is the law between the parties under Article 1134 of the French Civil Code is general, absolute and governs contracts whose performance extends to successive periods, just as it governs contracts of all other types. The Court held that “under no circumstances is it for the courts, however, fair their decision may

²¹⁵⁷ Van Houtte, Hans, *Changed Circumstances and Pacta Sund Servanda*, in Emmanuel Gaillard (ed.), *Transnational Rules in International Commercial Arbitration*, ICC Publication No. 480/4, Paris, 1993, at 111

²¹⁵⁸ Horn, Norbert, *Changes in Circumstances and the Revision of Contracts in Some European Laws and in International Law*, in Norbert Horn (ed.), *Adaptation and Renegotiation of Contracts in International Trade and Finance*, Antwerp, Boston, London, Frankfurt, Kluwer, 1985, at 17

²¹⁵⁹ Rivkin, David R., *Lex Mercatoria and Force majeure*, in Emmanuel Gaillard (ed.), *Transnational Rules in International Commercial Arbitration*, ICC Publication No. 480/4, Paris, 1993, at 174

appear to them to be, to take into account the time and circumstances in order to substitute new terms for those which have been freely accepted by the contracting parties.”²¹⁶⁰ This case is still considered the landmark case in the field of civil and commercial contracts. The subsequent case law reaffirmed the absolute nature of the contract as a “law” between the parties, even if the projections of the one of the parties turn out to be wrong. In another case, the Cour de Cassation considered a party as having undertaken the risk of the future rise in prices and emphasized the impossibility for the judge to substitute a presumed agreement for the agreement expressed by the parties.²¹⁶¹ Thus, the courts gave priority to Article 1134 (1), which consecrates the binding force of the contract, over Article 1134 (3), which contains the principle of good faith and Article 1135, which provides that the contract binds the parties not only according to its wording, but also to all the consequences, which equity, custom or statute give to the obligation according to its nature.²¹⁶²

Under French law, a mechanism similar to the concept of hardship was recognized only in relation to the administrative contracts by the Conseil d'Etat in the case of *Gaz de Bordeaux*.²¹⁶³ The case concerned the concession given by City of Bordeaux to a company for the provision of gas within the city for thirty years. The price to be paid for the gas was fixed by the contract. As a result of the First World War, the cost of coal increased fourfold in twenty months and the company claimed an increase in the price of gas. The Conseil held that the increase in the price of coal exceeded all reasonable expectations and the economy of the contract was entirely upset, so a solution must be found “which takes account both of the general interest, which demands the continuation of the company's service . . . and the special circumstances which do not allow the contract to be applied normally”. Thus, the case was remitted for assessment of an appropriate indemnity.²¹⁶⁴ This mechanism is called “revision pour imprévision” and applies to an administrative contract whose “structure is absolutely overturned owing to exceptional circumstances” provided that the event is definitive. In such a case, the public authorities are liable to pay indemnity such as to share equitably the exceptional burden. The foundation of the doctrine is the need to protect the public interest. There are two main reasons to justify the operation of *imprévision* in the administrative contracts: (i) the principle of the continuity of the public service, which would be interrupted in the absence of an adjustment, and (ii) the right of the person contracting with the public authorities to expect financial equilibrium within the contract.²¹⁶⁵ However, these reasons and the need to protect the public interest are not considered as justifying the operation of *imprévision* in the contracts between private parties.²¹⁶⁶ Even so, it is argued that, in rare

²¹⁶⁰ *Canal de Crappone*, Cass. Civ. 6 March 1876, D. 1876.I.93. Cited by Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1131

²¹⁶¹ Cass. Civ. 6 June 1921, D. 1021.I.73; Cited by Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1132-1133

²¹⁶² *Ibid.*, at 1133

²¹⁶³ Conseil d'Etat, March 30, 1916, S. 1916.3.17.

²¹⁶⁴ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 209-210

²¹⁶⁵ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1130

²¹⁶⁶ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at, at 211

cases involving a change in circumstances due to force majeure, the French courts awarded a contract modification under the label of compensation for damages.²¹⁶⁷

The strict position of French private law has been made more bearable by the parties to private contracts through the use of adaptation clauses and commercial arbitration.²¹⁶⁸ However, in the French legal doctrine of arbitration, there have been problems with the capacity of arbitrators to adapt contracts to changed circumstances, even if the parties agreed so. This is because an arbitral award is considered as a judicial act and, thus, it is argued that the role of an arbitrator, as a private judge, may not include performance of an “exclusively creative act”.²¹⁶⁹ Nevertheless, in practice, when the contract contains an arbitration clause and arbitrators are asked to give effect to a hardship clause, it is generally considered that there to be a dispute and the arbitrators therefore interpret or apply the disputed clause.²¹⁷⁰

The German Civil Code of 1900 did not include the doctrine of *clausula rebus sic stantibus*. However, in 1920, after the collapse of the Mark and in the wake of the ensuing hyperinflation, the German courts invoked the unwritten *clausula rebus sic stantibus* in order to adapt the price agreed in a contract in light of the extraordinary war-related price increases. This practice paved the way for the development of a case law pronouncing “the doctrine of the disappearance of the basis of transaction” on the basis of the principle of good faith under Section 242 of the German Civil Code.²¹⁷¹ The leading cases on the doctrine mainly concerned the situations that occurred in the context of major political upheavals, such as wars, inflation and regime changes. The doctrine has also been applied to cases concerning far less dramatic change of circumstances that do not have repercussions for society at large.²¹⁷² In the course of modernizing the German law of obligation in 2002, the case law was codified with a clear primacy of judicial adaptation of contract over termination in Section 313 of the Civil Code.

Section 313 (1) of German Civil Code provides that if circumstances upon which a contract was based have materially changed after conclusion of the contract and if the parties would not have concluded the contract or would have done so upon different terms if they had foreseen that change, adaptation of the contract may be claimed in so far as, having regard to all the circumstances of the specific case, in particular the contractual or statutory allocation of risk, it cannot reasonably be expected that a party should continue to be bound by the contract in its unaltered form. Section 313 (2) extends the principles of the first paragraph to the cases where the material assumptions of both parties that form the basis of the contract subsequently turn out incorrect. Section 313 (3) provides the secondary solution in cases where an adaptation is not possible or not reasonable by allowing the disadvantaged party to

²¹⁶⁷ Cass. 27. nov. 1950, *Gaz. Pal.* 1951.1.132. cited by Horn, Norbert, *Changes in Circumstances and the Revision of Contracts in Some European Laws and in International Law*, in Norbert Horn (ed.), *Adaptation and Renegotiation of Contracts in International Trade and Finance*, Antwerp, Boston, London, Frankfurt, Kluwer, 1985, at 23

²¹⁶⁸ *Ibid.*, at 18

²¹⁶⁹ Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 27

²¹⁷⁰ *Ibid.*, at 28

²¹⁷¹ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1138

²¹⁷² *Ibid.*, at 1145-1146

terminate the contract retroactively. With regard to the case of a contract for the performance of a recurring obligation, the termination operates with prospective effect.²¹⁷³ Since Section 313 does not mention any attempt of the parties to renegotiate the contract, it is generally understood that the parties are not under any obligation to negotiate in order to invoke Section 313.²¹⁷⁴ However, Section 313 emphasizes the exceptional character of the doctrine with regard to the principle of *pacta sunt servanda*, by providing stringent requirements: the changed circumstances or initial assumptions must have been material, the parties would not have concluded the contract if they had foreseen the supervening event, and binding one of the parties to the contract would be unreasonable.²¹⁷⁵

Under the common law, the hardship situations may become relevant to the extent that the doctrines of frustration and impracticability are more flexible notions than the force majeure or impossibility in civil law systems. In the House of Lords decision of *British Movietonews Ltd. v. London District Cinemas*, Viscount Simon stated that “The parties to an executory contract are often faced, in the course of carrying it out, with a turn of events which they did not at all anticipate - a wholly abnormal rise or fall in prices, a sudden depreciation of currency, an unexpected obstacle to execution, or the like. Yet this does not in itself affect the bargain they have made. If, on the other hand, a consideration of the terms of the contract, in the light of the circumstances existing when it was made, shows that they never agreed to be bound in a fundamentally different situation which has now unexpectedly emerged, the contract ceases to bind at that point - not because the court in its discretion thinks it just and reasonable to qualify the terms of the contract, but because on its true construction it does not apply in that situation.”²¹⁷⁶ Thus, in English Law, the question of frustration of contract has been treated by the courts as a question of interpretation.²¹⁷⁷ Viscount Simon added that “What distinguishes “frustration” cases is that the interpretation involves the consequence that, in view of what has happened, further performance is automatically ended... But there are, of course, many other examples where the court has to put an interpretation on the agreement made, not with the result that the contract is brought to an end by frustration, but with the result that the contract goes on and continues to bind the parties according to its true construction.”²¹⁷⁸ In the House of Lords decision of *Davis Contractors Ltd v. Fareham UDC*, Lord Radcliffe, noting that the data for decision in frustration cases are, on the one hand, the terms and construction of the contract, read in the light of the then existing circumstances and, on the other hand, the events which have occurred, stated that “In the nature of things there is often no room for any elaborate inquiry. The court must act upon a general impression of what its rule requires. It is for that reason that special importance is necessarily attached to the occurrence of any unexpected event that, as it were, changes the face of things. But, even so, it is not hardship or inconvenience or material loss itself which calls the principle of frustration into play. There must be as well such a change in the significance of the obligation

²¹⁷³ Rösler, Hannes, *Hardship in German Codified Private Law – In Comparative Perspective to English, French and International Contract Law*, *European Review of Private Law*, 15-4 (2007), at 490

²¹⁷⁴ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1147

²¹⁷⁵ *Ibid.*, at 1148

²¹⁷⁶ *British Movietonews Ltd. v. London District Cinemas* [1951] A.C. 166, at 185

²¹⁷⁷ Stone, Richard, & Ralph Cunnington, *Text, Cases & Materials on Contract Law*, Routledge-Cavendish, 2007, at 914

²¹⁷⁸ *British Movietonews Ltd. v. London District Cinemas* [1951] A.C. 166, at 186

that the thing undertaken would, if performed, be a different thing from that contracted for.”²¹⁷⁹

The English courts have exceptionally granted relief from contractual liability even where performance as to the letter of the contract was still possible but the purpose of the contract had been frustrated, as in the famous coronation case.²¹⁸⁰ The doctrine of frustration of purpose applies where the common purpose for which the contract was entered into cannot be carried out because of some supervening event. However, examples of this doctrine are extremely rare since the courts do not wish to provide an escape route for a party for whom the contract has simply become a bad bargain.²¹⁸¹ The contractual purpose will be frustrated only when “the contract becomes impossible of performance by reason of the non-existence of the state of things assumed by both contracting parties as the foundation of the contract.”²¹⁸²

It is generally accepted that the English courts have no power to adapt a contract to unforeseeable and fundamental change of circumstances in the event of contractual performance becoming more onerous, even if the parties so desire. The reason is the principle that the function of the courts is not to make a contract for the parties but to interpret the contract made by them. The adaptation of the contract price to the changed circumstances was an issue in the case of *Staffordshire Area Health Authority v. South Staffordshire Waterworks Co.* The dispute concerned a contract for supply of water concluded in 1929 between a water company and a hospital. The water company agreed to provide the hospital “at all times hereafter” with its requirements of water at fixed prices. By 1975, the price became derisory as the other ratepayers were paying a rate that was 20 times greater than the agreed prices promised to the hospital.²¹⁸³ The company gave 6 months notice of termination of the contract, and asked the court to declare that the contract was terminated by its notice and that from the date of termination of the contract, the company is entitled to charge the plaintiffs for the supply of water at the normal rate.²¹⁸⁴ The Court of Appeal held that the company was entitled to a declaration that the agreement had been terminated by reasonable notice. The majority of the court did not grant a declaration that from the date of termination the water company was entitled to charge the authority at the normal rate.²¹⁸⁵

Denning LJ, in his minority view, stated that “It seems to me that we have reached the point which Viscount Simon contemplated in *British Movietonews Ltd. v. London and District Cinemas Ltd.*... So here the situation has changed so radically since the contract was made 50 years ago that the term of the contract “at all times hereafter” ceases to bind: and it is open to

²¹⁷⁹ *Davis Contractors Ltd v Fareham UDC* [1956] AC 696

²¹⁸⁰ *Krell v. Henry* [1903] 2 K.B. 740. (C.A.) where the defendant, CS Henry, agreed by contract to rent a flat from the plaintiff, Paul Krell, for the purpose of watching the coronation procession of Edward VII. The parties agreed on a price of £75. Henry paid a deposit of £25 to Krell for the use of the flat, but when the procession did not take place on the days originally set, on the grounds of the King’s illness, Henry refused to pay the remaining £50. The court held the contract frustrated in purpose by the cancellation of the coronation since it could be inferred from the dealings of the parties that the principle aim of the hiring was the witnessing of the coronation

²¹⁸¹ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 313

²¹⁸² Vaughan Williams LJ in *Krell v. Henry* [1903] 2 K.B. 740 (C.A.)

²¹⁸³ *Staffordshire Area Health Authority v. South Staffordshire Waterworks Co.* [1978] W. L. R., 1387, at 1393

²¹⁸⁴ *Ibid.*, at 1389

²¹⁸⁵ *Ibid.*, at 1388-1389

the court to hold that the contract is determined by reasonable notice..., in the past 50 years, the whole situation has changed so radically that one can say with confidence: “The parties never intended that the supply should be continued in these days at that price.” Rather than force such unequal terms on the parties, the court should hold that the agreement could be and was properly determined in 1975 by the reasonable notice of six months. This does not mean, of course, that on the expiry of the notice the water company can cut off the supply to the hospital. It will be bound to continue it. All that will happen is that the parties will have to negotiate fresh terms of payment... it seems to me plain that the contract of 1929 should be up-dated so as to have regard to the effect of inflation.”²¹⁸⁶ Denning LJ then commended a solution to the parties “in the hope that it will settle their difficulties without troubling the courts further”.²¹⁸⁷

Although Goff LJ and Cumming-Bruce LJ agreed with the result that the contract was terminable on reasonable notice, their reasoning differed from that of Denning LJ. The majority allowed the contract to be ended by the water company, on the basis of a construction of the parties’ intentions that the contract was a contract for an indefinite period which could be brought to an end after a reasonable period of notice, but they did not found the decision on the existence of an implied term that the agreement should not continue to bind the parties upon the emergence of circumstance, which the parties did not then foresee. Cumming-Bruce LJ explained that “I am not attracted against the history of fact in this case either by the argument founded upon frustration or upon implied term akin to frustration, and I can find no authority which leads me to the view that the changing value of money has the effect in relation to domestic as compared to international contracts of giving rise to the operation of an implied term that the contract should only persist while money maintained the value or more or less the value that it had at the date of the formation of the agreement.”²¹⁸⁸ Given that the case was treated as the termination of a contract for indefinite duration by reasonable notice, the issue of adaptation of the contract to the changed circumstances was not relevant to the reasoning of the majority. Thus, Goff LJ stated that “It may well be that the point of principle as to determinability having been decided, the parties will now be able to reach a compromise... It is to be hoped that they will be able to do that so as in effect to apply the principle of the 1929 agreement to the changed circumstances of today, but that is a matter for them”.²¹⁸⁹ It is observed that the approach of Denning LJ in this case is not generally accepted by the English courts.²¹⁹⁰

English law has also traditionally rejected the power of the arbitral tribunal to adapt the contract to changed circumstances.²¹⁹¹ The existence of a dispute is one of the cornerstones of the definition of arbitration in English law.²¹⁹² An arbitrator is supposed to solve legal

²¹⁸⁶ Ibid., at 1398-1399

²¹⁸⁷ Ibid., at 1399

²¹⁸⁸ Ibid., at 1406

²¹⁸⁹ Ibid., at 1404

²¹⁹⁰ Treitel, G. H, *The Law of Contract*, Thomson/Sweet & Maxwell, 11th ed., 2003, at 944

²¹⁹¹ Schmitthoff, Clive M., *Hardship and Intervener Clauses*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 415

²¹⁹² *Sutcliffe v. Thackrah* [1974] 1 All E.R. 859, 862: Lord Reid stated that judicial duties “do not arise until there is a dispute: The parties to a dispute agree to submit the dispute for decision. Each party to it submits his evidence and contention in one form or another. It is then the function of the arbitrator to form a judgment and reach a decision.”

disputes, i.e. disputes over existing rights and duties, while the adaptation of the contract is considered as an activity of rearranging the contractual relationship on behalf of the parties. In this sense, adaptation is not deemed as arbitration, and the adaptation of the contract cannot, on this interpretation, constitute an arbitral award which could be enforced or challenged.²¹⁹³ This interpretation has been based on the perception that an arbitrator could only have the same powers as the judge, who determines the existing rights and duties of the parties and cannot make the contract for them by supplementing new terms at his discretion.²¹⁹⁴ However, there still remained the question of whether a disagreement between the parties as to the future terms of their agreement can be considered as a “dispute” in the sense of a requirement for arbitration. In *Sykes v. Fine Fare*, the parties concluded a contract for the supply of poultry. The contract provided a fixed price for the weekly quantity of poultry during the first year of the contract, but thereafter “such other figures as might be agreed”. The contract was to last not less than five years. It was agreed that any difference between the parties should be referred to arbitration.²¹⁹⁵ The parties could not agree, and the Court of Appeal treated the failure to agree as a “difference” within the arbitration clause and thus capable of determination by arbitration. Denning LJ stated that “when an agreement has been acted upon and the parties, as here have been put to great expense in implementing it, we ought to imply all reasonable terms so as to avoid any uncertainties. In this case there is less difficulty than others because there is an arbitration clause, which liberally construed is sufficient to resolve any uncertainties which the parties have left.”²¹⁹⁶ Thus, in his view, the contract was interpreted to contain an implied term that a reasonable quantity of poultry should be delivered, and that the task of the arbitrator was the determination of what constitutes a “reasonable quantity”. On the other hand, Danckwert LJ based his argument on the wording of the arbitration clause and stated that “it seems to me that the word ‘difference’ is particularly apt to describe that situation [where the parties have not agreed]”.²¹⁹⁷ While under the old law such a wide understanding of dispute was not self-evident, it clearly underlies the English Arbitration Act of 1996, which, in Section 82, provides that “‘dispute’ includes any difference.”²¹⁹⁸

In US law, the requirement of impossibility was loosened to allow excuse in circumstances where the cost of performance increased so dramatically as to render performance commercially impracticable. The doctrine of commercial impracticability was first expressed in the case of *Mineral Park Land Co. v. Howard*, where the Supreme Court of California stated that “A thing is impossible in legal contemplation when it is not practicable, and a thing is impracticable when it can only be done at excessive and unreasonable cost.”²¹⁹⁹ However, a mere change in the degree of difficulty or expense due to such causes as increased wages, prices of raw materials, or costs of construction, unless well beyond the normal range, does not amount to impracticability since it is this sort of risk that a fixed-price contract is intended

²¹⁹³ Van Houtte, Hans, *Changed Circumstances and Pacta Sunt Servanda*, in Emmanuel Gaillard (ed.), *Transnational Rules in International Commercial Arbitration*, ICC Publication No. 480/4, Paris, 1993, at 122

²¹⁹⁴ Kroll, Stefan, *Contractual Gap-Filling by Arbitration Tribunals*, *International Arbitration Law Review*, 2 (1999), at 16

²¹⁹⁵ *F.G.Sykes (Wessex) Ltd v. Fine Fare Ltd* [1967] 1 Lloyd's Rep 53

²¹⁹⁶ *Ibid.*, at 57

²¹⁹⁷ *Ibid.*, at 60

²¹⁹⁸ Kroll, Stefan, *Contractual Gap-Filling by Arbitration Tribunals*, *International Arbitration Law Review*, 2 (1999), at 15

²¹⁹⁹ *Mineral Park Land v. Howard* 172 Cal. 289, 156 at 458 (1916)

to cover.²²⁰⁰ It is argued that the doctrine imposes a risk sharing rule, around which the parties must contract explicitly and deliberately. Thus, to the extent that the commercial impracticability discharges the obligor's obligation to perform, in cases where the performance is deemed to be impracticable when the cost rises above a certain amount, the doctrine provides that the risk that the cost will increase to any level up to that amount is borne by the obligor, while the risk of the cost rising above that amount is allocated to the obligee.²²⁰¹

US law also recognizes the doctrine of frustration of purpose. Although it is not explicitly recognized in the UCC, Restatement (Second) of Contracts provides in Section 265 that "Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary." The main difference between the doctrine of frustration of purpose and impracticability is that the former does not require an impediment to performance of either party for its application. There are three requirements for the discharge of that party's duty under Section 265. First, the purpose that is frustrated must have been a principal purpose of that party in making the contract, in the sense that the object must be so completely the basis of the contract that, as both parties understand, without it the transaction would make little sense. Second, it is not enough that the transaction has become less profitable for the affected party or even that he will sustain a loss. The frustration must be so severe that it is not fairly to be regarded as within the risks that he assumed under the contract. Third, the non-occurrence of the frustrating event must have been a basic assumption on which the contract was made.²²⁰²

In US law, some commentators object to the all-or-nothing allocation of the losses caused by cost increases beyond a certain amount and suggest that all losses above that amount should be shared between the parties, particularly in the long-term contractual relationships, by adjusting the agreement in the face of economic hardship.²²⁰³ Some of those commentators

²²⁰⁰ Comment d on Section 261 of the Restatement (Second) of Contracts (1981)

²²⁰¹ Triantis, George, Contractual Allocations of Unknown Risks: A Critique of the Doctrine of Commercial Impracticability, *University of Toronto Law Journal*, 42-4 (1992), at 482

²²⁰² Comment a on Section 265 of the Restatement (Second) of Contracts (1981)

²²⁰³ Hillman, Robert A., Court Adjustment of Long-Term Contracts: An Analysis under Modern Contract Law, *Duke Law Journal*, 1 (1987), at 1-33 (Hillman argues that the court adjustment is appropriate in some circumstances that are sufficiently identifiable. He specifies two situations in which court adjustment is appropriate: "agreement model" which occurs when a party reasonably expects the other to adjust in case of a serious disruption and which accounts for the "relational" realities of many contract settings through a theory of the parties' implicit risk allocation; and "gap model", which occurs when the party to suffer substantial harm from continued performance has no reasonable expectation of adjustment, but the parties simply fail to allocate the risk of some calamitous event, and which is based primarily on the fairness principle that the parties should agree to share unallocated losses. Thus, in these situations, when an unanticipated disruption causes calamitous losses to a party, a duty to adjust may arise. If the court finds a duty to adjust, the court can adjust the contract for the parties in modest ways. In his view, in many situations court adjustment should be limited to adjustment of the duration of the agreement.) Trakman, Leon E., Winner Take Some: Loss Sharing and Commercial Impracticability, *Minnesota Law Review*, 69 (1985), at 506-518 (Trakman argues that as a general principle, each party should take precautions against the risks associated with its performance and assume responsibility only for that proportion of performance risks and ensuing losses that are within its "control". Accordingly, the courts may properly adjust the performance responsibility of the parties in accordance with their respective abilities to foresee and avert the risk of loss. In his view, the court may focus on what the parties did contemplate or reasonably should have contemplated at the time of contracting in determining the proportion of the loss each party should be held to have actually assumed. Moreover, he argues that the system of allocating performance

also seem to be in favor of implication of the duty of renegotiation on the basis of the principle of good faith in the cases of commercial impracticability.²²⁰⁴ In cases of impracticability of performance and frustration of purpose, Section 272 of Restatement Second Contracts essentially allows the courts to grant relief on such terms as justice requires including protection of the parties' reliance interests. Particularly, with regard to sales contracts, Official Comment 6 to Section 2-615 of UCC states that "In situations in which neither sense nor justice is served by either answer when the issue is posed in flat terms of 'excuse' or 'no excuse', adjustment under the various provisions of this Article is necessary, especially the sections on good faith, on insecurity and assurance and on the reading of all provisions in the light of their purposes, and the general policy of this Act to use equitable principles in furtherance of commercial standards and good faith." However, the general language of these texts is criticized for providing little concrete guidance to courts to adjust the contract, and for prompting the courts to search for an absolute excuse on grounds of impossibility or commercial impracticability.²²⁰⁵

In general, the US courts are extremely reluctant to substitute their judgment for that of the contracting parties or to disturb bargained for allocations of risk, and, in cases of impracticability and frustration of purpose, the courts almost always focus on the "relief" or "excuse" as opposed to adjustment.²²⁰⁶ An exceptional and controversial case where the court adjusted the contract in a hardship situation was the case *Aluminum Company of America v*

losses should reflect a policy in favor of minimizing public harm measured by the extent of diminished efficiency sustained by the economy as a whole, in the presence of clear evidence of socioeconomic harm.) Eisenberg, Melvin A., *Impossibility, Impracticability, and Frustration*, *Journal of Legal Analysis*, 1-1 (2009), at 254-259: (Eisenberg argues that in cases of impossibility, impracticability, or frustration, more complex adjustments may be required, and in making those adjustments the courts should have power to take into account in appropriate cases ex post considerations, that is "gains and losses to both parties that either arose under the contract prior to the occurrence of the unexpected circumstance or resulted proximately from, or were made possible by, the occurrence". In his view, this power is not a license to reallocate gains and losses on the basis of distributional considerations, but a recognition of the reality presented by many unexpected-circumstances cases and must be exercised within the general framework of the parties' enterprise. He suggests that in appropriate cases, ex post considerations either support complete judicial relief, or militate against any judicial relief, but in some cases, ex post considerations suggest an adjustment of the contract. In his view, however, in rare cases, ex post considerations may suggest that the contract be judicially adjusted.)

²²⁰⁴ Trakman, Leon E., *Winner Take Some: Loss Sharing and Commercial Impracticability*, *Minnesota Law Review*, 69 (1985), at 516: "In order to promote interparty settlement of impracticability suits, courts should also require that each party demonstrate its good faith in attempting to settle. Those parties who fail to exercise good faith should assume additional responsibility for the loss.... Where a party has evidenced bad faith in settling, the court may properly adjust the apportionment of loss in response to that bad faith."; Hillman, Robert A., *Court Adjustment of Long-Term Contracts: An Analysis under Modern Contract Law*, *Duke Law Journal*, 1 (1987), at 4-17: "Even if the supply contract contains no express agreement to adjust, the circumstances existing at the time of contracting may demonstrate that the parties intended such a duty... Apart from any duty based on trade custom, course of dealing, or course of performance, a party may have a good-faith duty to adjust... A duty to adjust,..., can override express contract terms such as fixed-price terms or even price-adjustment formulas, provided that the parties reasonably expect those terms to yield to the implied duty.... Assuming the court finds a duty to adjust and the parties have failed to adjust the question of fashioning an appropriate remedy confronts the court."

²²⁰⁵ Trakman, Leon E., *Winner Take Some: Loss Sharing and Commercial Impracticability*, *Minnesota Law Review*, 69 (1985), at 482

²²⁰⁶ Fucci, Frederick R., *Hardship and Changed Circumstances as Grounds for Adjustment or Non-Performance of Contracts*, *Practical Considerations in International Infrastructure Investment and Finance*, American Bar Association, Section of International Law, Spring Meeting (April 2006) available at <http://www.cisg.law.pace.edu/cisg/biblio/fucci.html>

Essex Group Inc.²²⁰⁷ The decision is also illustrative of the approach of the US courts to the requirements and interrelationship of the doctrines of frustration of purpose and commercial impracticability as well as the doctrine of mutual mistake of fact. The Aluminum Company of America (“ALCOA”) and Essex had entered into a long-term contract under which ALCOA was to convert alumina provided by Essex and return molten aluminum to Essex for further processing. The price of each pound of aluminum was subject to an escalation formula under which non-labor costs were to be escalated in accordance with changes in the Wholesale Price Index for Industrial Commodities (“WPI-IC”). The adjusted price was subject to a “ceiling”, but without a “floor”. The contract was to run from 1967 until 1983, with Essex’s option to extend it until the end of 1988. In 1973, OPEC actions to increase oil prices and unanticipated pollution control costs increased ALCOA’s electricity costs, which comprised its “principal non-labor cost factor” under the contract, greatly and unforeseeably beyond the WPI-IC indexed increase in the contract price.²²⁰⁸ ALCOA argued that the shared objectives of the parties with respect to the use of the WPI-IC were completely and totally frustrated, and that both ALCOA and Essex made a mutual mistake of fact in agreeing to use the WPI-IC to escalate non-labor costs. ALCOA sought reformation or equitable adjustment of the agreement so that, the pricing formula with respect to the non-labor portion of the production charge will be changed to eliminate the WPI-IC and substitute the actual costs incurred by ALCOA for the non-labor items.²²⁰⁹

The United States District Court for the Western District of Pennsylvania considered that unforeseeable rise in ALCOA’s non-labor production costs, which resulted in mistake in prediction of range of variation between indexed price and product costs, constituted a mutual mistake of fact and a risk which contract did not allocate and, therefore, ALCOA was entitled to relief under Indiana law. The Court noted that “The parties took pains to avoid the full risk of future economic changes when they embarked on a twenty-one year contract involving services worth hundreds of millions of dollars. To this end they employed a customary business risk limiting device-price indexing-with more than customary sophistication and care.”²²¹⁰ Essex pointed out that at the time of the trial ALCOA had shown a net profit of \$9 million on the contract. However, the Court found that during the last three years ALCOA suffered increasingly large out of pocket losses. The Court considered that if the contract were to expire at the time of the trial that net profit of \$9 million would raise doubts concerning the materiality of the parties’ mistake, but Essex had the power to keep it in force until 1988, and ALCOA proved that over the entire life of the contract it will lose, out of pocket, in excess of \$60 million, and the whole of this loss will be matched by an equal windfall profit to Essex. The Court held that this proof clearly established that the mistake had the required material effect on the agreed exchange.²²¹¹ Then the question was whether ALCOA, by omitting a floor provision, accepted the risk of any and every deviation of the selected index from its costs, no matter how great or how highly improbable. The Court noted that “The contract was drafted by sophisticated, responsible businessmen who were intensely conscious of the risks inherent in long term contracts and who plainly sought to limit the risks of their undertaking. The parties’ laudable attention to risk limitation appears in many ways”. The Court stated that “In the context of the formation of the contract, it is untenable to argue that ALCOA

²²⁰⁷ 499 F. Supp. 53 (W.D. Pa. 1980).

²²⁰⁸ *Ibid.*, at 58

²²⁰⁹ *Ibid.*, at 56

²²¹⁰ *Ibid.*, at 63

²²¹¹ *Ibid.*, at 67-68

implicitly or expressly assumed a limitless, if highly improbable, risk. On this record, the absence of an express floor limitation can only be understood to imply that the parties deemed the risk too remote and their meaning too clear to trifle with additional negotiation and drafting.”²²¹² According to the Court, “Both parties knew that the use of an objective price index injected a limited range of uncertainty into their projected return on the contract... [and] consciously undertook a closely calculated risk rather than a limitless one.”²²¹³

The Court held that, under the doctrines of impracticability and frustration of purpose, ALCOA was entitled to reformation of long-term contract where, following execution of the contract, ALCOA's non-labor production costs rose greatly beyond the foreseeable limits of risk under non-labor component of objective pricing formula which was tied to WPI-IC and where, without judicial relief or economic changes that were not presently foreseeable, ALCOA stood to lose in excess of \$60 million out of pocket during remaining term of contract. The Court noted that the doctrines of impracticability, of frustration of purpose, and of mistake discharge an obligor from his duty to perform a contract where a failure of a basic assumption of the parties produces a grave failure of the equivalence of value of the exchange to the parties.²²¹⁴ Thus, the Court considered that there is a substantial area of similarity between the three doctrines, and no further discussion is required to establish that the non-occurrence of an extreme deviation of the WPI-IC and ALCOA's non-labor production costs was a basic assumption on which the contract was made, and ALCOA neither assumed nor bore the risk of the deviation beyond the foreseeable limits of risk. The Court, nevertheless, emphasized that “The focus of the doctrines of impracticability and of frustration is distinctly on hardship.”²²¹⁵ Finally, the Court considered that the doctrines of impracticability and of frustration focus on different kinds of disappointment of a contracting party: impracticability focuses on occurrences which greatly increase the costs, difficulty, or risk of the party's performance, while the doctrine of frustration focuses on a party's severe disappointment which is caused by circumstances which frustrate his principal purpose for entering the contract.²²¹⁶

The Court held that ALCOA satisfied the requirements of both doctrines. The impracticability of its performance was clear on the grounds that the increase in its cost of performance was severe enough to warrant relief, that the circumstances surrounding the contract showed a deliberate avoidance of abnormal risks, and that the risk of a wide variation between the WPI-IC and ALCOA's costs was unforeseeable in a commercial sense and was not allocated to ALCOA in the contract.²²¹⁷ As to ALCOA's claim of frustration, the Court noted that the results of the decisions on inflationary depreciation of money in US and other jurisdictions, such as Germany, where courts and legislatures have repeatedly acted to relieve parties from great and unexpected losses, would be readily explained in terms of frustration of purpose, and the frustration which those decisions involved was a frustration of the purpose to earn money or to avoid losses. Given that the requirements of risk allocation and gravity of injury

²²¹² Ibid., at 68-69

²²¹³ Ibid., at 69

²²¹⁴ Ibid., at 70

²²¹⁵ Ibid., at 72

²²¹⁶ Ibid., at 73

²²¹⁷ Ibid., at 73-76

were fulfilled in the case, the Court held ALCOA was entitled to relief on its claim of frustration of purpose.²²¹⁸

Subsequently, the Court discussed the question of framing a remedy for ALCOA. According to the Court, the US courts have traditionally applied three remedial rules in cases of mistake, frustration and impracticability. First, some courts have declared that no contract ever arose because there was no true agreement between the parties, or because the parties were ignorant of existing facts which frustrated the purpose of one party or made performance impracticable. Secondly, the courts have held that a contract is voidable on one of the three theories. Thirdly, in both cases, where one or both parties have performed under the supposed contract, the courts have awarded appropriate restitution in the light of the benefits the parties have conferred on each other in order to prevent unjust enrichment. The courts in such cases have often called this remedy “reformation” in the loose sense of “modification.”²²¹⁹ The Court stated that “To decree rescission in this case would be to grant ALCOA a windfall gain in the current aluminum market. It would at the same time deprive Essex of the assured long term aluminum supply which it obtained under the contract and of the gains it legitimately may enforce within the scope of the risk ALCOA bears under the contract. A remedy which merely shifts the windfall gains and losses is neither required nor permitted by Indiana law.”²²²⁰

The Court held that “A remedy modifying the price term of the contract in light of the circumstances which upset the price formula will better preserve the purposes and expectations of the parties than any other remedy. Such a remedy is essential to avoid injustice in this case.”²²²¹ During the trial the parties agreed that a modification of the price term to require Essex to pay ALCOA the ceiling price specified in the contract would be an appropriate remedy if the Court held for ALCOA. However, the Court noted that a price fixed at contract ceiling could redound to ALCOA's great profit and to Essex's great loss in changed circumstances. Thus, the Court held that for the duration of the contract the price for each pound of aluminum converted by ALCOA shall be the lesser of the Price A or Price B. Price A shall be the contract ceiling price computed periodically as specified in the contract. Price B shall be the greater of the price specified in the contract, computed according to the terms of the initial contract, or the price which yields ALCOA a profit of one cent per pound of aluminum converted.²²²²

b. International Instruments

The CISG is not explicit as to whether a disturbance which does not render performance temporarily or permanently impossible, but makes it considerably more difficult, can be considered as an impediment in the context of Article 79.²²²³ Scholarly opinions are divided on whether the situation of hardship is governed by Article 79. It is argued that the CISG

²²¹⁸ Ibid., at 78

²²¹⁹ Ibid.

²²²⁰ Ibid., at 79

²²²¹ Ibid.

²²²² Ibid., at 80

²²²³ Enderlein, Fritz & Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary*, Oceana Publications, 1992, at 324

contains a gap in this respect which should be filled in accordance with Article 7.²²²⁴ However, it is also noted that, in such a gap filling, the principle of good faith must not be used to bypass explicit provisions of Article 79, which ensure both contractual justice and the security of transactions. In this view, if Article 79 were to be regarded as the legal basis of the hardship doctrine in international sales, harmony would be jeopardized and the aim of the CISG, as stated in Article 7(1), would not be attained.²²²⁵ Others argued in favor of allowing changes in the circumstances in the form of economic difficulties to be considered as impediments within the meaning of Article 79 when they constitute a barrier to performance that is comparable to other types of exempting causes.²²²⁶

The latter approach was also adopted by the CISG Advisory Council, in its Opinion No. 7. The Advisory Council noted that the legislative as well as the drafting history of Article 79 is not conclusive enough to warrant a conclusion that the hardship problem was meant to be excluded or included within its scope, but, as of 2007, there were no reported decisions whereby a court exempted a party from liability on the ground of hardship.²²²⁷ In the opinion of the Advisory Council, as the language of Article 79 does not expressly equate the term “impediment” with an event that makes performance absolutely impossible, a party may invoke hardship as an exemption from liability under Article 79 in a situation of genuinely unexpected and radically changed circumstances, i.e. in truly exceptional cases of “economic impossibility”. The Advisory Council stated that “It is certainly not possible or even convenient to attempt a definition of hardship, beyond accepting that the impediment may entail a situation of “economic impossibility” which, while short of an absolute bar to perform, imposes what in some legal systems is conceptualized as a “limit of sacrifice” beyond which the obligor cannot be reasonably expected to perform.”²²²⁸

Moreover, the Advisory Council maintained that in a situation of hardship under Article 79, the court or arbitral tribunal may provide further relief consistent with the CISG and the general principles on which it is based. According to the Council, it is possible to infer from the obligation to interpret the Convention in good faith a duty imposed upon the parties to renegotiate the terms of the contract with a view to restore a balance of the performances.²²²⁹ In 2009, the Belgian Supreme Court held, in a case governed by the CISG, that a party invoking a change of circumstances fundamentally disrupting the contractual equilibrium is entitled to request renegotiation of the contract. In the case, the parties had concluded an agreement for the sale of steel tubes. After the conclusion of the contract and before delivery, the price of steel unexpectedly increased by 70%, but the agreement contained no price

²²²⁴ Kessedjian, Catherine, *Competing Approaches to Force Majeure and Hardship*, *International Review of Law and Economics*, 25 (September 2005), at 418

²²²⁵ Tallon, Denis, *Article 79 C. Massimo Bianca & Michael Joachim Bonell (eds.), Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 593

²²²⁶ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 484; Enderlein, Fritz & Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary*, Oceana Publications, 1992, at 324; Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 102

²²²⁷ CISG-AC Opinion No. 7, *Exemption of Liability for Damages under Article 79 of the CISG*, Rapporteur: Professor Alejandro M. Garro, Columbia University School of Law, New York, N.Y., USA, 2007, at para. 27, 32

²²²⁸ *Ibid.*, at para. 38

²²²⁹ *Ibid.*, at para 40

adjustment clause. The seller tried to renegotiate a higher contract price, but the buyer refused and insisted on delivery of the goods at the price agreed upon. The Belgian Supreme Court pointed out that while the CISG contained an express provision for force majeure as an exempting event in Article 79(1), this did not mean that it implicitly excluded the relevance of hardship and possibility of re-negotiation of the price. The Supreme Court pointed out that in order for gaps to be filled in a uniform manner, regard must be had to the general principles governing the law of international commerce, and concluded that according to such principles as incorporated *inter alia* in the UNIDROIT Principles, a party invoking a change in circumstances fundamentally disrupting the contractual equilibrium, had the right to request re-negotiation of the contract. Accordingly, the Supreme Court confirmed the decision of the Court of Appeal granting the seller the right to request the re-negotiation of the price.²²³⁰

The Advisory Council stated that in case negotiations fail, there are no guidelines under the Convention for a court or arbitrator to "adjust," or "revise" the terms of the contract so as to restore the balance of the performances but, even if a decision maker were not ready to stretch the principle of good faith for that purpose, Article 79(5) may be relied upon by a court or arbitral tribunal to determine what is owed to each other, thus "adapting" the terms of the contract to the changed circumstances.²²³¹ However, in general, the commentators, including those who maintain that the general definition of "impediment" is broad enough to cover extreme cases of hardship, are of the opinion that, under the Convention, hardship can only be invoked as an exemption from liability for non-performance, but cannot lead to a possible adaptation of the contract, unless expressly provided for by the parties.²²³²

Both the UNIDROIT Principles and the PECL provide specific rules for hardship situations. It is argued that the inclusion of rules on hardship in the UNIDROIT Principles was motivated by the reason that hardship clauses have become very common in international contracts, and it was a response to the request frequently made by practitioners at the time the Principles were being prepared.²²³³ Under Article 6.2.1 of the UNIDROIT Principles, a party is bound to fulfill its obligations, even if its performance has become more onerous. The Official Comment to this provision refers to the principle of sanctity of contracts, and requires that "performance must be rendered as long as it is possible and regardless of the burden it may impose on the performing party".²²³⁴ Thus, a party cannot get out of a contract merely because

²²³⁰ Supreme Court of Belgium, 19 June 2009, *Scafom International BV v. Lorraine Tubes S.A.S.* an English translation is available at <http://cisgw3.law.pace.edu/cases/090619b1.html>; also see; Veneziano, Anna, UNIDROIT Principles and CISG: Change of Circumstances and Duty to Renegotiate according to the Belgian Supreme Court, *Uniform Law Review*, (2010), at 137 et seq.

²²³¹ CISG-AC Opinion No. 7, Exemption of Liability for Damages under Article 79 of the CISG, Rapporteur: Professor Alejandro M. Garro, Columbia University School of Law, New York, N.Y., USA, 2007, at para. 40

²²³² Tallon, Denis, Article 79 C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 591; Bonell, Michael Joachim, *An International Restatement of Contract Law: the UNIDROIT Principles of International Commercial Contracts*, Transnational Publishers, 3rd ed., 2005, at 324 fn. 86

²²³³ Fontaine, Marcel, *The UNIDROIT Principles: An Expression of Current Contract Practice?*, Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration, 2002, at 97

²²³⁴ Official Comment 1 to Article 6.2.1 of the UNIDROIT Principles

it has turned out to be unprofitable.²²³⁵ Article 6.2.1 is considered as an important reminder that the general duty is to perform and that relief is very much the exceptional case.²²³⁶

Under Article 6.2.2, a hardship event is defined as one which “fundamentally alters the equilibrium of the contract either because the cost of a party’s performance has increased or because the value of the performance a party receives has diminished.” The Official Comment to the 1994 edition of the Principles sought to give some guidance on ascertaining the meaning of “fundamental”. While recognizing the importance of the circumstances in each particular case, the Official Comment stated that “If, however, the performances are capable of precise measurement in monetary terms, an alteration amounting to 50% or more of the cost or the value of the performance is likely to amount to a “fundamental” alteration.” However, this sentence was dropped from the 2004 and 2010 versions of the Principles because the figure of 50 per cent had been criticized on the grounds that it was too low and arbitrary.²²³⁷ In the absence of guidance in the Official Comment, it is left to the courts and tribunals to determine what is “fundamental”.²²³⁸ Article 6.2.2 provides that the conditions allowing a disadvantaged party to claim the hardship include: (a) the events occur or become known to the disadvantaged party after the conclusion of the contract; (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract; (c) the events are beyond the control of the disadvantaged party; and (d) the risk of the events was not assumed by the disadvantaged party.

Article 6.2.3 of the UNIDROIT Principles provides rules on the effects of hardship according to which the disadvantaged party is “entitled to request renegotiations” of the contract. Upon failure to reach agreement within a reasonable time, either party may resort to the court or arbitral tribunal. The decision maker may, if reasonable, terminate the contract at a date and on terms to be fixed, or adapt the contract with a view to restoring its equilibrium. The Official Comments state that “the court will seek to make a fair distribution of the losses between the parties. This may or may not, depending on the nature of the hardship, involve a price adaptation. However, if it does, the adaptation will not necessarily reflect in full the loss entailed by the change in circumstances, since the court will, for instance, have to consider the extent to which one of the parties has taken a risk and the extent to which the party entitled to receive a performance may still benefit from that performance.”²²³⁹ Article 6.2.3 (4) states that the court may terminate or adapt the contract only when this is reasonable. The Official Comments explain that “the circumstances may even be such that neither termination nor adaptation is appropriate and in consequence the only reasonable solution will be for the court either to direct the parties to resume negotiations with a view to reaching agreement on the adaptation or the contract, or to confirm the terms of the contract as they stand”.²²⁴⁰

²²³⁵ Lando, Ole, CISG and Its Followers: A Proposal to Adopt Some International Principles of Contract Law, in: *American Journal of Comparative Law*, 53 (2005), at 399-400

²²³⁶ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 716

²²³⁷ UNIDROIT 2003 - Study L - Doc. 85, Rome, April 2003, at 15.

²²³⁸ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 719

²²³⁹ Official Comment 7 to Article 6.2.3 of the UNIDROIT Principles

²²⁴⁰ *Ibid.*

Article 6:111 of the PECL contains a mechanism that deals with the issue of hardship. The reason for inclusion of such a mechanism in the PECL is explained to be that the majority of countries in the European Community have introduced into their law some mechanism intended to correct any injustice, which results from an imbalance in the contract caused by supervening events which the parties could not reasonably have foreseen when they made the contract, and in practice contracting parties adopt the same idea, supplementing the general rules of law with a variety of clauses, such as "hardship" clauses.²²⁴¹ Article 6:111 of the PECL first provides the reminder that party is bound to fulfill its obligations even if performance has become more onerous. Unlike the UNIDROIT Principles, which refers to fundamental alteration of the equilibrium of the contract in the determination of a hardship event, Article 6:111 requires that contract must become "excessively" burdensome because of a change of circumstances. The Official Comments explain that "The mere fact that a contract has become more onerous than expected is not enough: to adopt the phrase used by the Italian Civil Code, art. 1467, the contract must have become "excessively" burdensome".²²⁴² Article 6:111 provides a list of conditions with regard to the change of circumstances for the applicability of hardship mechanisms: the change of circumstances must have occurred after the time of conclusion of the contract, the possibility of a change of circumstances was not one which could reasonably have been taken into account at the time of conclusion of the contract, and the risk of the change of circumstances is not one which, according to the contract, the party affected should be required to bear.

When the conditions of Article 6:111 are satisfied, the parties are bound to enter into negotiations with a view to adapting the contract or ending it. It is also provided in Article 6:111 that, the court may award damages for the loss suffered through a party refusing to negotiate or breaking off negotiations contrary to good faith and fair dealing. Essentially, the court will intervene only in the last resort, and its first aim should be to preserve the contract.²²⁴³ If the parties fail to reach agreement within a reasonable period, the court may end the contract at a date and on terms to be determined by the court or adapt the contract in order to distribute between the parties in a just and equitable manner the losses and gains resulting from the change of circumstances. The modification of the clauses of the contract must be aimed at re-establishing the balance within the contract by ensuring that the extra cost imposed by the unforeseen circumstances are borne equitably by the parties. In the Official Comments, it is stated that "Unlike the risks which result from total impossibility, the risks of unforeseen events are to be shared." It is also noted that the court may intervene in a variety of ways and, the proposed solutions in the text are merely options. The court may reject the application, extend the period for performance, increase or reduce the price or the contract quantity, or order a compensatory payment. The Official Comments, however, make it clear that although the court can modify clauses of the contract, it cannot rewrite the entire contract. If the adaptation of the contract amounts to imposing a new contract on the parties, the only option open to the court would be to declare the contract ended. The Official Comments state that when the court declares the contract ended, it will have to fix the date, as from which the contract is ended, taking into account how much of it has been performed, and this date will determine the extent of restitution which will become due. Under the PECL, the court may

²²⁴¹ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 322

²²⁴² *Ibid.*, at 323

²²⁴³ *Ibid.*, at 325

also order the payment of an addition to the price or of compensation for a limited period and the termination of the contract at the end of the period.²²⁴⁴

Both set of rules under the UNIDROIT Principles and the PECL aim to keep the contract alive, despite an imbalance in the parties' rights and duties, but the terms of contract will then have to be modified. Moreover, both sets of rules are not mandatory and the parties are free to agree that a particular change in circumstances shall not affect the terms of the contract and to adopt different remedial consequences for hardship situations.²²⁴⁵ However, the UNIDROIT Principles and the PECL have been criticized for going too far beyond reasonable commercial standards with the unjustified imposition of the third party intervener's will in the absence of a hardship clause. It is argued that, apart from the fact that hardship in general and adaptation in particular endanger commercial relations by creating an undesirable level of instability, adaptation is hardly likely to be accepted by the parties, since the intervention of the third party, lacking background knowledge of the specific transaction in question, would always be an arbitrary exercise that might jeopardize the whole relationship.²²⁴⁶

c. Contracting Practices

The term "hardship" is frequently used in international contracting practices even in contracts drafted in languages other than English.²²⁴⁷ International contract drafters have formulated a great variety of clauses dealing with the situations of hardship. As to the requirements of hardship, the contracting parties resort to "contractual equilibrium", criteria of fairness, good faith and equity, or specific terminology imposing thresholds, or adopt a mixed approach. As to the effects of changed circumstances on the contract, the parties provide the possibility to renegotiate, terminate or adjust the contract by means of various mechanisms.

In 1985, the ICC drew up "drafting suggestions" with various alternatives in relation to hardship clauses, which may serve as a basis for discussions of contract drafting.²²⁴⁸ These suggestions did not include a standard clause that can be incorporated in a contract by reference. The document defined hardship as the occurrence of events not contemplated by the parties, which fundamentally alter the equilibrium of the contract, thereby placing an excessive burden on one of the parties in the performance of its contractual obligations. The document provided a procedure for renegotiation in which the aggrieved party shall make a request for revision within a reasonable time from the moment it becomes aware of the event and of its effect on the economy of the contract, and then the parties shall consult each other with a view to revising the contract on an equitable basis, in order to ensure that neither party suffers excessive prejudice. It is also stated that the request for revision does not of itself suspend performance of the contract. If the parties fail to agree on revision of the contract within a time-limit of 90 days of the request, the document provided four alternatives: (1) the

²²⁴⁴ Ibid., at 326

²²⁴⁵ Ibid., at 322-323; Fontaine, Marcel, *The UNIDROIT Principles: An Expression of Current Contract Practice?*, Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration, 2002, at 98

²²⁴⁶ See comments of Professor Fabio Bortolotti in Conference report of "Force Majeure and Hardship" - Paris (France), 8 March 2001 organized by the International Chamber of Commerce (ICC) published in 6 Uniform Law Review (2001), at 103

²²⁴⁷ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 456

²²⁴⁸ ICC Publication No. 421

contract remains in force in accordance with its original terms; (2) either party may refer the case to the ICC Standing Committee for the Regulation of Contractual Relations²²⁴⁹ for a non binding revision, and if the parties do not agree on revision, the contract remains in force in accordance with its original terms; (3) either party may bring the issue of revision before the arbitral forum, or the competent court; and (4) either party may refer the case to the ICC Standing Committee for the Regulation of Contractual Relations for a binding revision.

These suggestions were updated by the ICC into a model hardship clause in 2003.²²⁵⁰ The ICC Hardship Clause of 2003 starts with the principle of sanctity of contracts, and provides that a party to a contract is bound to perform its contractual duties even if events have rendered performance more onerous than could reasonably have been anticipated at the time of the conclusion of the contract. Thus, the threshold for the application of hardship is higher than just an increase in the cost or a decrease in value of the performance. The ICC Hardship Clause requires the party invoking it to prove that “(a) the continued performance of its contractual duties has become excessively onerous due to an event beyond its reasonable control which it could not reasonably have been expected to have taken into account at the time of the conclusion of the contract; and that (b) it could not reasonably have avoided or overcome the event or its consequences”.

Under the ICC Hardship Clause of 2003, the hardship results in a duty to negotiate for both parties within a reasonable time of the invocation of the Clause, in order to come up with “alternative contractual terms which reasonably allow for the consequences of the event.” As a drastic departure from the UNIDROIT Principles and the PECL, the ICC Hardship Clause provides for the termination of the contract at the will of the aggrieved party when the alternative contractual terms are not agreed by the other party to the contract.²²⁵¹ Therefore, in line with the criticisms against the position of UNIDROIT Principles and the PECL as to hardship, the ICC Hardship Clause of 2003 does not provide for adaptation of the contract to the changed circumstances, but reflects the approach of Article 1467 of the Italian Civil Code.²²⁵² Article 1467 provides that in continuing or periodic contracts, or where performance is deferred, if performance by one of the parties has become excessively onerous as a result of the occurrence of exceptional or unforeseeable events, the party liable for performance under

²²⁴⁹ The ICC published rules on the adaptation of contracts in 1978, in view of the theoretical and technical difficulties about the capability of arbitrators to adapt the contract to changed circumstances and about the diverse solutions proposed by national contract laws. (ICC Publication, No. 326). The rules provided for the appointment of a third party which may adapt the contract terms. Under these rules, parties have the choice of having their contract adapted either by a single person, or by a panel of three members. For that purpose, the ICC established a Standing Committee for the Regulation of Contractual Relations which may be asked to appoint a third-party intervener with necessary technical qualifications. The parties could provide that the adaptation take the form of a mere recommendation or a binding decision. In the latter case, the decision will be binding upon the parties to the extent as the contract in which it is deemed to be incorporated. However, the rules in question were withdrawn by the ICC in 1994 because they had been never used by that time. Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 27

²²⁵⁰ ICC Publication No. 650

²²⁵¹ Kessedjian, Catherine, Competing Approaches to Force Majeure and Hardship, *International Review of Law and Economics*, 25 (September 2005), at 425

²²⁵² ICC Force Majeure Clause 2003, ICC Hardship Clause 2003, ICC Publication No. 650, Note b and e, at 16-17

such conditions may apply for termination of the contract.²²⁵³ Article 1467 also provides that the party against which the termination is demanded can prevent termination by offering to modify equitably the conditions of the contract. Thus, the Italian approach restricts both the aggrieved party's right to terminate the contract and the decision maker's power to adapt the contract, since it requires the other party to offer alternative terms, only upon which the decision maker can render a judgment about whether those terms are equitable and reasonably allow for the consequences of a hardship event and, if affirmative, adapt the contract to the changed circumstances in accordance with those terms.²²⁵⁴

As specified in the Notes to the ICC Hardship Clause, the aggrieved party's right to terminate the contract only arises if the other party does not offer reasonable alternative terms to save the contract.²²⁵⁵ However, since the approach of Italian rule with regard to judicial adaptation of contract is not included in the Clause, if the aggrieved party fails unreasonably to accept an offer for alternative terms made by the other party, terminates the contract and no longer performs, the other party may only claim unjust termination. It is argued that this approach aims at providing an incentive for the parties to work out their own solution through renegotiation.²²⁵⁶ This solution is considered as a more appropriate response to the needs of the parties since the decision maker can only decide on termination of the contract if the conditions for hardship are met, and cannot take the parties' place by "redrafting" the contract on their behalf.²²⁵⁷ Interestingly, however, none of the ICC Model Mergers & Acquisitions Contract, Share Purchase Agreement, the ICC Model Contract for the Turnkey Supply of an Industrial Plant and the ICC Model Commercial Agency Contract contains a hardship clause or a reference to the ICC Hardship clause, although, except for commercial agency, they all contain clauses incorporating or largely inspired by the ICC Force Majeure clause.

The FIDIC Conditions deal explicitly with many events of hardship and their consequences in order to offer a fair balance of risks between the contracting parties and to ensure that the risks incurred by the parties to a contract are clearly identifiable and understood.²²⁵⁸ Since the first edition of the FIDIC Conditions was published in 1957, the FIDIC Conditions have contained provisions entitling the contractor to claim additional costs and/or time from the employer when the contractor encounters specifically defined unforeseeable events.²²⁵⁹ The FIDIC Conditions refer to the notions of "Employer's risks" and the allocation of the responsibility for damage to the works, rather than the language of hardship, in determining

²²⁵³ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1146

²²⁵⁴ Brunner, Christoph, *Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration*, Kluwer Law International, 2009, at 507-508

²²⁵⁵ ICC Force Majeure Clause 2003, ICC Hardship Clause 2003, ICC Publication No. 650, Note e, at 17

²²⁵⁶ Brunner, Christoph, *Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration*, Kluwer Law International, 2009, at 506

²²⁵⁷ Bortolotti, Fabio, *Drafting and Negotiating International Commercial Contracts: A Practical Guide*, Paris: ICC Publication no. 671, 2008, at 183-184

²²⁵⁸ Bunni N.G., *The FIDIC Forms of Contract: the Fourth Edition of the Red Book, 1992, the 1996 Supplement, the 1999 Red Book, the 1999 Yellow Book, the 1999 Silver Book*, Blackwell Pub., 3rd ed., 2005, at 105

²²⁵⁹ Seppälä, Christopher R., *Contractor's Claims Under The FIDIC Contracts (1999 Edition)*, available at http://www1.fidic.org/resources/contracts/icc_apr04/icc01_christopher_seppala.asp

when the risk deriving from those events should have been borne by one party or by the other.²²⁶⁰

The basic allocation of risk between the Contractor and the Employer is for damage to the works before take over in Sub-Clauses 17.2 to 17.4 of the FIDIC Conditions, in which the principles are unchanged from the old versions. Until the Taking-Over Certificate is issued for the works, if any loss or damage happens to the works, materials and plant, other than due to “Employer’s risks”, the Contractor must rectify this loss or damage at its own cost. “Employer’s risks” are generally events or circumstances over which neither party will have any control, such as war, hostilities, unforeseeable operations of the forces of nature and alike, or events or circumstances caused by the Employer, directly or indirectly. If the loss or damage occurs due to an Employer’s risk, the Contractor must rectify this loss or damage to the extent required by the Employer or the Engineer requires rectification. Where the Employer or the Engineer requires rectification and the Contractor suffers delay and/or incurs cost in the performance of the contract, the Contractor may be entitled to an extension of time and to any such cost.²²⁶¹

Moreover, under Sub-Clause 4.12 of the FIDIC Conditions, if the Contractor encounters “physical conditions”, which means natural physical conditions and manmade and other physical obstructions and pollutants, including sub-surface and hydrological conditions but excluding climatic conditions, the Contractor shall continue executing the Works, using such proper and reasonable measures as are appropriate for the physical conditions. If and to the extent that the Contractor encounters physical conditions, which are unforeseeable, and suffers delay and/or incurs costs due to these conditions, the Contractor shall be entitled to an extension of time, and payment of any such cost. Under Sub-Clause 13.7, Contractor may claim extension of time and any cost attributable to a change in the Laws of the Country where the construction site is located. Under Sub-Clauses 8.4 and 8.5, the Contractor shall be entitled to an extension of time for the performance of the contract in the cases of exceptionally adverse climatic conditions, unforeseeable shortages in the availability of personnel or goods caused by epidemic or governmental actions, or, subject to certain conditions, the unforeseeable delay or disruption caused by relevant legally constituted public authorities.

Under Sub-Clause 20.1, if the Contractor considers himself to be entitled to any extension of the time and/or any additional payment, under any clause of the FIDIC Conditions or otherwise in connection with the contract, the Contractor shall give notice to the Engineer within a certain period of time.²²⁶² In case of the failure to give notice, the time shall not be extended, the Contractor shall not be entitled to additional payment, and the Employer shall be discharged from all liability in connection with the claim. The Engineer shall respond with approval or with disapproval and detailed comments to agree or determine the extension of

²²⁶⁰ Draetta, Ugo, Force Majeure Clauses in International Trade Practice, *International Business Law Journal*, (1996), at 351

²²⁶¹ Seppälä, Christopher R., FIDIC's New Standard Forms of Contract – Risks, Force Majeure, Claims and Termination, *International Business Law Journal*, (2000), at 1013

²²⁶² Sub clause 20.1 is the same in all three Books for major works except that as, in the Silver Book, there is no Engineer, and his role is performed there by the Employer. Unlike the old Books, not only does this sub clause regulate claims for additional payment, as in the past, but it also regulates claims for extension of time. Seppälä, Christopher R., *Contractor's Claims Under The FIDIC Contracts* (1999 Edition), available at http://www1.fidic.org/resources/contracts/icc_apr04/icc01_christopher_seppala.asp

the time, and/or the additional payment. If the Engineer does not respond within the determined timeframe or the parties are dissatisfied with the Engineer's ruling, the parties may refer this issue to the dispute resolution mechanisms.

Therefore, except for the entitlements to adaptation of the contract, such as the inclusion of additional costs into the contract price and extension of time, and force majeure events under Clause 19, which discharge the Contractor from performance of its obligations, the Contractor is under the burden of bearing the consequences of any hardship situation which the Contractor is supposed to have taken into consideration in determining the price. The Contractor is also under the duty to notify the hardship situations when covered by the Conditions in order to be entitled to adaptation, which means extension of time for completing the works and the increase in contract price due to the payment of additional costs. The FIDIC Conditions simply deal with the problem of hardship in terms of the contractual risk allocation between the Contractor and the Employer, according to the equitable criteria exercised by Engineers and, in some cases, by the arbitrators.²²⁶³

2. Arbitral Decision Making

In the doctrine, it is argued that the interrelated doctrines of *pacta sunt servanda* and *rebus sic stantibus* are often relevant to the arbitral decision making, and the *clausula rebus sic stantibus* is usually considered as a rule of *lex mercatoria*.²²⁶⁴ Under *lex mercatoria*, pursuant to the basic principle of sanctity of contracts, the parties are certainly bound by the obligations they have undertaken, but it is still questionable whether consideration must be given to an established rule in the order of international commerce, which commands a single solution for the unforeseen contingencies that change the initial circumstances under which contractual obligations have been accepted, without rendering their performance temporarily or permanently impossible. The conflicting approaches of the national legal systems, the wide powers granted to the decision makers under the international restatements of contract principles and the great variety of the relevant clauses in the international contracting practices preclude the decision maker applying *lex mercatoria* to discover such established rules in the order of international commerce, which could constitute a doctrine of hardship.

The national legal systems provide three types of solutions for the situations of hardship: the contract is preserved, terminated or adjusted. First solution provides that, the contract must be performed, however onerous the performance may be, unless there is an impossibility of performance, namely force majeure. This is the French solution for private contracts, as opposed to administrative contracts. It is argued that this strict application of the *pacta sunt servanda* constitutes an incentive for the parties to introduce adequate clauses in their contract, such as indexation clauses, hardship clauses, or adaptation clauses.²²⁶⁵ The second solution provides that the changed circumstances entail the disappearance of contract even if the unforeseen event does not reach to the level of force majeure. This is the English law solution inasmuch as frustration is a more flexible notion than force majeure. It is argued that,

²²⁶³ Draetta, Ugo, Force Majeure Clauses in International Trade Practice, *International Business Law Journal*, (1996), at 352

²²⁶⁴ Carbonneau Thomas E., A Definition of and Perspective upon the *Lex Mercatoria* Debate, in Thomas E. Carbonneau (ed.), *Lex mercatoria and arbitration: a discussion of the new law merchant*, Kluwer Law International, Rev. ed., 1998, at 18

²²⁶⁵ Tallon, Denis, Hardship, in Arthur Hartkamp, Martijn Hesselink, Ewoud Hondius, Carla Joustra & Edgar du Perron (eds.), *Towards A European Civil Code*, Kluwer Law International, 2nd ed., 1998, at 329

contrary to the belief that English law does not encourage the adjustment of bargains in the event of contractual performances becoming more onerous, English law underlines that it is for the parties to do the adjusting, and not for the courts.²²⁶⁶

The third solution is that of German law and, arguably and to a truly limited extent, US Law. The court may either terminate the contract or adjust it in order to allocate the unforeseen loss equitably between the parties. In the ALCOA case, the United States District Court concluded with a general remark in order to further justify its extraordinary solution of adjustment: "If the law refused an appropriate remedy when a prudently drafted long term contract goes badly awry, the risks attending such contracts would increase. Prudent business people would avoid using this sensible business tool... Much of the story of modern business law and of modern management concerns deals with the problem of risk limitation... Corporate managers are fiduciaries... Attention to risk limitation is essential to the fiduciary duty of corporate managers. Courts must consider the fiduciary duty of management and the established practice of risk limitation in interpreting contracts and in the application of contract doctrines such as mistake, frustration and impracticability.... while the Court willingly concedes that the managements of ALCOA and Essex are better able to conduct their business than is the Court, in this dispute the Court has information from hindsight far superior to that which the parties had when they made their contract... and a rule that the Court may not act would have the perverse effect of discouraging the parties from resolving this dispute or future disputes on their own. Only a rule which permits judicial action of the kind the Court has taken in this case will provide a desirable practical incentive for businessmen to negotiate their own resolution to problems which arise in the life of long term contracts."²²⁶⁷

Thus, the abstractions from the national legal systems and international restatements may support the view that it is one of the concerns in the different approaches to the issue of hardship that the parties should resolve themselves through cooperation the problems arising from an unforeseeable contingency, which does not render the performance of the contract temporarily or permanently impossible, but disturbs the equilibrium of the contract by increasing the cost of performance or decreasing its value. This concern seems to be most clearly pronounced in Article 1467 of Italian Civil Code, which provides that, in the event that the performance becomes excessively onerous, the judge may terminate the contract but the

²²⁶⁶ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 311

²²⁶⁷ 499 F. Supp. 53 (W.D. Pa. 1980), at 89-92 Also, in the Westinghouse case, the United States District Court, having concluded that Westinghouse's nonperformance was not excused by commercial impracticability, stated that this was not to be construed as precluding the Court from giving consideration to the hardship of performance in deciding the question of remedy. Thus, the Court held that in view of uncertainty in record and in view of good faith demonstrated by the parties, parties would be granted 90 days within which to attempt to reach agreement as to relief to be afforded for breach of contract, before court would decide whether to order specific performance. The Court stated that "While the Court is fully cognizant of the difficulty of fashioning a sufficiently specific decree should the parties be unable to reach agreement, and should the Court conclude that specific enforcement is appropriate considering the various other factors, the Court believes that, with the assistance of the parties, a workable and appropriate decree would be achieved. The Court, however, fervently hopes that it will not be called upon to draft a decree, not because it would be difficult, but rather because the Court is convinced that the parties themselves are in a far better position to find an equitable solution." *Westinghouse Electric Corp. Uranium Contracts Litigation*, 517 F. Supp. 440 (E.D.Va. 1981), at 461. However, it should be noted that neither Alcoa decision nor Westinghouse decision represents the mainstream practice of the US courts, yet both decisions "have been the raw materials for serious scholarly urging of more of the same." Perillo, Joseph M., *Force Majeure and Hardship under the UNIDROIT Principles of International Commercial Contracts*, in *Contratación internacional, Comentarios a los Principios sobre los Contratos Comerciales Internacionales del Unidroit*, Universidad Nacional Autónoma de México - Universidad Panamericana, 1998, at 130-131

other party may offer an equitable indemnity in order to save the contract. Such a concern is also appropriate in the spontaneous order of international commerce, due to the importance of the utilization of the knowledge of the particular circumstances of time and place, of which beneficial use can be made only if the decisions depending on it are left to the parties or are made with their active cooperation. Thus, the decision maker, applying *lex mercatoria*, should be willing to encourage and direct the parties to renegotiate for adjusting their contracts, in the change of circumstances, which does not render performance impossible, but brings about costs that are not covered by the parties' express or implied risk allocations. The unconditional acceptance of the solution of adaptation may lead to a dangerous degree of discretionary power whereby the specific contractual rights and obligations of the parties come under the judicial review through the principle of good faith and fair dealing for the sole reason that the circumstances are materially modified, generating significant imbalance between the respective obligations. Such a review should not disregard the knowledge of particular circumstances of time and place, and the parties' risk allocation contemplated under their bargain.

a. Risk Allocation

In abstract terms, the concept of hardship, which leads to some form of relief from the ascertainable meaning of the contract, should require that such performance must become excessively onerous due to an event, the risks of which have been neither contemplated nor allocated by the parties through the articulated rules. In ICC Case No 9479, the claimant and defendant, both Italian companies, were created upon the dissolution of a partnership specialized in the manufacture of textiles. The claimant inherited the right to use the registered trademark, whereas the defendant was entitled to use the company name only as a means of identifying itself as a corporate entity or as the producer of the fabrics manufactured by it, but not as a trademark. To this end, the two parties entered into an agreement giving the defendant clear and detailed instructions on the way in which the company name was to be reproduced on labels and finished items of clothing. The claimant argued that the defendant breached this agreement by reproducing the company name in such a way that customers were misled and that the trademark was depreciated. The defendant argued that the parties' agreement on the use of the trademark should be amended in light of the European trademark Directive EEC/89/104, claiming it had suffered hardship since the introduction of this directive.²²⁶⁸ The arbitral tribunal determined that any question other than the validity of the agreement had to be decided according to the provisions of the agreement in the light of, and, in case of need, supplemented by the usages of international trade, having regard whenever necessary to "international public policy".²²⁶⁹

The defendant maintained that the EEC/89/104 Directive, which was issued after the execution of the agreement, explicitly allowed the owner of a name to use it in its commerce, as long as it does so in a manner consistent with honest and fair principles, even when said name constitutes the trademark of another businessman. The defendant argued that, since it entered into the agreement at a time when Italian law restricted drastically the use of a name as a trademark when such name was used as a trademark by someone else, the liberalization introduced by the European Directive put the defendant in a situation of hardship. The defendant relied on Articles 6.2.1-6.2.3 of the UNIDROIT Principles, and requested an equitable modification of the agreement so that, on the territory of the European Union, the

²²⁶⁸ ICC Award in Case No 9479, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 67

²²⁶⁹ *Ibid.*, at 69

defendant might benefit from the liberal solutions resulting from the application of the Directive.²²⁷⁰ Since no national law had been made applicable to the agreement, and the provisions of the agreement did not contemplate the possibility of its modifications on equitable grounds, the arbitral tribunal considered the usages of international trade in order to supplement the provisions of the agreement. In this respect, the tribunal recognized the UNIDROIT Principles as an accurate representation, although incomplete, of the usages of international trade. On the basis of Articles 6.2.1-6.2.3 of the UNIDROIT Principles, the arbitral tribunal held that it would be entitled to make an equitable modification of the agreement, but it was not convinced that the defendant was faced with a situation, which may be characterized as "hardship".²²⁷¹

The tribunal noted that "the issuing of the EEC Directive did not alter in any way the equilibrium of the Agreement among the parties. The situation of [claimant] and its affiliates remain unaffected insofar as their entitlement to the . . . trademark is not concerned by the Directive. [Defendant] does not meet any new difficulty in complying with the restriction on the use of the . . . name." The tribunal stated that "[Defendant]'s position, in a nutshell, is that it would have had no reason to enter into the Agreement should the EEC Directive have been introduced before April 1987. This has nothing to do with hardship, which is a notion which may play a role when the performance of a contract is at stake but has no function in the formation of contracts. Even if it is probable that [Defendant] would have entered into the Agreement, as drafted in 1987, after the adoption of the EEC Directive in 1989, a subsequent evolution of the legislative context of a contract does not constitute a hardship when it does not destroy the balance of the parties' respective obligations. Moreover, without denying that the parties had in mind the Italian . . . law when they executed the Agreement, it was not made to be enforced in Italy only nor in Europe. The Agreement is a global arrangement, due to be enforced in the whole world."²²⁷² Irrespective of the fact that the adoption of EEC Directive did not constitute a situation of hardship, the tribunal decided to dismiss the defendant's contention that the agreement be modified in so far as its effects in the territory of the European Union are concerned, on the ground that it was in direct contradiction with the intention of the parties to organize their relations as to the use of the trademark by harmonized solutions applicable in any jurisdiction, whatever be the content of the law in that jurisdiction.²²⁷³ Thus, the tribunal rejected the defense of hardship, since the parties regulated the risks arising from the applicability of the default rules of the national laws, which deal with the rights of the owner of a name to use it in its commerce as far as their territories are concerned, through an agreement, which defined, with a view of its worldwide application, the respective status of the owner of the trademark and of the owner of the name, irrespective of the legal precepts of any national law.

In most cases, the element of foreseeability at the time of contracting will be relevant to the determination of whether the parties contemplated and allocated the risk of alleged event of hardship. In ICC Case No 7177, the tribunal dismissed the argument based on *clausula rebus sic stantibus* since the contract was concluded at a time of political instability, and changing circumstances were foreseeable. The case concerned contracts for the international sale of oil concluded between a Greek agent of an Antiguan Corporation having an office in

²²⁷⁰ Ibid.

²²⁷¹ Ibid., at 70

²²⁷² Ibid., at 70-71

²²⁷³ Ibid., at 71

Switzerland, as seller, and a Greek purchaser. Under the first contract, which was signed in October 1990, the purchaser was to buy a given volume of oil for the period November 1990 to March 1991. Two weeks after Iraq invaded Kuwait and United Nations armed forces started their land offensive, a second contract was signed to buy diesel, with deliveries scheduled for February-April 1991. Military operations ended on 28 February 1991, but the price of petroleum on the international markets fell. The parties met to renegotiate the price of the petroleum under the contract. They were unable to agree, and the seller terminated the contract on the grounds of fundamental changes in the market. The purchaser initiated arbitration proceedings.²²⁷⁴

The tribunal determined that Greek law was the substantive law of the contract.²²⁷⁵ Article 388 of the Greek Civil Code provided that “if the circumstances on which the parties, having regard to good faith and business usage, mainly based a synallagmatic contract, subsequently changed for extraordinary and unforeseeable reasons, and if, as a result of this change, performance of the obligation, taking into account the counter-obligation, became inordinately onerous for the obligor, the matter may request the court to adjust his obligation at its discretion to a suitable extent, or to rescind the whole of the contract or the part not carried out. If the rescission of the contract is decided upon, the obligations of both parties are extinguished and the parties have a mutual obligation to return whatever they have received, pursuant to the provisions relating to the unjust enrichment”.²²⁷⁶ The defendant argued that, Article 388 being applicable, the tribunal may either rescind the contract and release the parties from the non-performed part thereof, or adjust the performance to an appropriate level by reducing the price by an amount which reflects the value of the performance of the opposing party. The tribunal stated that “Nobody at the outset of the . . . war could know how long it would last. As usual in case of war, there was a difference of opinion as to its probable duration. A war may end at any time and no one can unilaterally base a contract on the assumption that it will last for a certain period; by doing so, a party simply miscalculates its risks and cannot ask for application of a rule which requires the unforeseeability of an event.” The tribunal considered that even if it is very seldom that the date when the war will end can be safely predicted, a war necessarily ends, and the fact that a war can end at any time is not unpredictable. Thus, according to the tribunal, nothing prevents the parties from agreeing that, should the war end before or after a given date, contractual provisions are to be amended. The tribunal stated that “If [Defendant] based its purchasing policy on the assumption that the war was to last long, [Defendant] was simply wrong and the purpose of Article 388 is certainly not to correct a commercial miscalculation.” Thus, the tribunal held that the conditions for applicability of Article 388 of the Greek Civil Code were not met.²²⁷⁷

The decision maker applying *lex mercatoria* should carefully analyze the risk allocation between the parties that is indicated by the articulated rules, which consist of the terms of the contract and the default rules chosen by the parties. Even if the articulated rules do not contain a hardship rule or they contain such a rule, which lacks the necessary specificity to cover the event in question, the decision maker should consider whether other terms of the contract or default rules chosen by the parties provide any guidance about which party had assumed the

²²⁷⁴ Leboulanger, Philippe, Some Issues in ICC Awards Relating to State Contracts, ICC International Court of Arbitration Bulletin, 15-2 (2004), at 100

²²⁷⁵ ICC Partial Award in Case No. 7177, 1993, ICC International Court of Arbitration Bulletin, 7-1 (1996), at 89

²²⁷⁶ ICC Partial Award in Case No. 7177, 1993, ICC International Court of Arbitration Bulletin, 15-2 (2004), at 107

²²⁷⁷ *Ibid.*

risk associated with the relevant hardship event. The absence of specific terms or the inclusion of a specific risk in the contract may itself be a risk allocation. The parties may have agreed to consider specific risks and no others, and the party who will suffer from the risk's materialization may have decided that the expected loss from the risk is not worth the costs that would have to be incurred to identify it and allocate it expressly elsewhere.²²⁷⁸

In the case of *Questech Inc. v. Iran*, the Iran US Claims Tribunal decided to apply *clausula rebus sic stantibus*, but the reasoning of the tribunal, as reflected in the award, suggests, to some extent, that the risk of the change of circumstances that lead to the application of the *clausula* was essentially allocated to the claimant according to the interpretation of the contract by the Tribunal. The claimant, Questech, contended that the respondent, the Ministry of Defense, failed to comply with the contractual requirements for termination of the contract. The contract was part of a project to modernize and expand Iran's electronic intelligence gathering system, and provided for Questech to evaluate the planning and implementation of a training program conducted by another company, and to certify student achievement in the program.²²⁷⁹ The Tribunal found that the respondent terminated its contract with Questech due to its deliberate policy decision not to continue with American contractors in a project that related to secret military intelligence operations in the presence of the transformations arising from the Islamic Revolution in Iran. The Tribunal noted that the contract contained no provision that dealt directly with the consequences of the respondent's right to make such a policy decision and to terminate the contract unilaterally. Moreover, the contract did not allow the respondent to terminate it for its own convenience. A prior contract between the claimant and the Imperial Iranian Air Force contained a clause permitting termination whenever the Air Force determined it was in its best interests. According to the tribunal, the absence of such a clause in the contract in dispute confirmed that the parties did not intend the respondent to be able to terminate it for its convenience. However, the tribunal found an indication in the contract that the parties recognized that the respondent might cancel the contract even in the absence of either force majeure or default by the claimant. The contract provided that "In the event the Contract is cancelled due to Force Majeure or the Employer cancels the Contract for any reason except the Contractor's negligence, all Bank guarantees of good performance of work will be immediately released." The Tribunal considered that this provision, while not offering a comprehensive set of legal consequences for any unilateral termination of the contract, showed that the parties envisaged that the respondent could cancel the contract for other reasons than the ones explicitly stated in the contract.²²⁸⁰

The Tribunal stated that "the Contract ... was rooted in military cooperation, and even belonged to a highly secret intelligence gathering system. As such it touched on especially sensitive aspects of the State partner's defence interests and policy. In this particular situation the political relationship between the States concerned was of greater importance than in ordinary commercial relations, and in this case even more than with regard to contracts for the sale of less sensitive military equipment or services. If, during the performance of a contract like the present one, these circumstances undergo fundamental changes which the parties had not foreseen, then a consequence may be that a contract party is not barred from opting for a termination of the contract in such a situation."²²⁸¹ The tribunal stated that the concept of

²²⁷⁸ Gillette, Clayton P., *Commercial Rationality and the Duty to Adjust Long-Term Contracts*, *Minnesota Law Review*, 69 (1984-1985), at 538

²²⁷⁹ *Iran-US Claims Tribunal, Questech Inc. v. Iran*, 9 IRAN-U.S. C.T.R., at 108

²²⁸⁰ *Ibid.*, at 121

²²⁸¹ *Ibid.*, at 121-122

“changed circumstances, also referred to as *clausula rebus sic stantibus*, has in its basic form been incorporated into so many legal systems that it may be regarded as a general principle of law; it has also found a widely recognized expression in Article 62 of the Vienna Convention on the Law of Treaties of 1969.” However, considering wider and narrower formulations of the *clausula* in different legal systems and certain differences in its practical application, the tribunal stated that “it might be argued that ... it would not be easy to establish a common core of such a general principle of law”. Nevertheless, the Tribunal found the basis for the application of the doctrine of hardship in the express wording of Article V of the Claims Settlement Declaration, which “mandated the Tribunal to “tak[e] into account relevant usages of the trade, contract provisions and changed circumstances” when deciding “all cases”, thereby mentioning “changed circumstances” on the same level as “contract provisions”.²²⁸²

The tribunal held that “The fundamental changes in the political conditions as a consequence of the Revolution in Iran, the different attitude of the new government and the new foreign policy especially towards the United States which had considerable support in large sections of the people, the drastically changed significance of highly sensitive military contracts as the present one, especially those to which United States companies were parties, are all factors that brought about such a change of circumstances as to give the Respondent a right to terminate the Contract.” Although, the Tribunal based its decision on the principle of changed circumstances, which in its view, “may be invoked in the absence of express provisions regulating the termination of a contract”, its following statement indicates that the claimant could have foreseen that a change in the regime in Iran may result in the cancellation of contract, but it did not act to allocate this risk elsewhere through the contract: “taking into account the nature of this Contract as well as the fact that its contract Party was a government entity which would be particularly affected by potential changes of the type described above, the Claimant could have been aware that such changes in this particular area were more foreseeable than in other fields of contractual relations. The Claimant could therefore not expect that the Contract would remain unaffected by changes in such a highly sensitive military domain.”²²⁸³

As to the consequence of the respondent's termination of the contract, the Tribunal held that the respondent was obliged to compensate the claimant for the damages that the claimant has suffered from such a termination. This compensation included reimbursement for costs incurred, represented by invoice amounts rendered and not paid including profits to the time of termination, as well as for other direct costs, but did not comprise future profits, which the claimant might have made had the contract continued, because, in the tribunal's view, that would imply that the respondent was under an obligation to continue the contract, which was not the case due to the change of circumstances.²²⁸⁴

In his Separate Opinion, Howard M. Holtzmann a member of the Tribunal, agreed with the amount of damages awarded in the case, but considered that “changed circumstances” resulting from a political policy decision of the Iranian Government cannot be a basis for determining that Government's contractual liability and, therefore, the doctrine of *clausula rebus sic stantibus*, cited in the award, was entirely inapplicable.²²⁸⁵ In his view, the measure

²²⁸² Ibid., at 122-123

²²⁸³ Ibid., at 123

²²⁸⁴ Ibid., at 123-124

²²⁸⁵ Ibid., at 138

of compensation to be paid by the respondent for its actions in unilaterally terminating the contract should be determined by the terms of the contract itself and, under the provisions of the contract, the respondent would likewise be obligated to compensate the claimant for work performed and costs incurred under the contract, but not for profits lost because of the termination. According to Holtzmann, the award ignored the fact that the contract in its basic structure and by its wording provided the respondent with complete control over the amount of work to be done by the claimant, and this necessarily included a power to cancel the contract in its entirety.²²⁸⁶ Under the contract, when the Respondent exercised its right to "omit" services, the claimant would "only be paid for work actually performed under this Contract" and "[i]f the level of effort or other expenses actually required to perform the work are more or less than [the estimated maximum price of the Contract], the contract price will be adjusted accordingly." Moreover, the parties clearly envisioned that the contract might be terminated completely, for as noted in the Award, Article 7.4 provided for the release of all bank guarantees of good performance if "the Contract is cancelled due to Force Majeure or the Employer cancels the Contract for any reason except the Contractor's negligence."²²⁸⁷

Thus, Holtzmann stated that the legal consequences of the termination of the contract were governed by the contract itself: the respondent was obligated to compensate the claimant at the contractual rates for work performed and for other costs incurred under the contract, but not required to compensate the claimant for future profits that the claimant might have earned had the contract continued, because upon termination of services payment was to be adjusted to reflect only "work actually performed," and because the claimant could have no reasonable expectation of continuing its performance and earning all of its hoped-for profit.²²⁸⁸ Holtzmann concluded that "the Contract in this case provided the Respondent with a right to terminate the Contract and determines the compensation to be paid to the Claimant because the Respondent's exercise of that right. As a result, there is no need to invoke the doctrine of changed circumstances or to speculate about the political conditions in Iran in 1979 and the reasons for the termination, particularly since no evidence was presented upon which to base the speculation in the Award. Finally, the doctrine is in any event wrongly applied in the Award in this case."²²⁸⁹

Given that the outcome of the case would remain the same, the diverging approaches in the award and in the separate opinion could be combined through an interpretation to the effect that the claimant undertook an implied risk, which arose from the nature and other terms of the contract. The risk was that the respondent could terminate the contract on the basis of a political decision arising from a change of circumstances, and deprive the claimant of its claim for future profits lost because of such a termination. Thus, in essence, the tribunal can be considered as holding that the claimant, who could have contemplated the risk and allocated it elsewhere at the time of contracting, should incur the loss arising from the risk's materialization, in the absence of indications as to the specific reallocation of the relevant risk in the contract, on the basis of its other provisions. Such an interpretation is partly supported by both the award and the separate opinion.

²²⁸⁶ Ibid., at 147

²²⁸⁷ Ibid., at 148

²²⁸⁸ Ibid., at 149

²²⁸⁹ Ibid., at 150

It would be wrong to assume that the risks of unforeseen contingencies are not allocated by contract because they are not specifically contemplated by the parties. Before considering the adjustment in the contract due to unforeseen contingencies that make the performance excessively onerous, the decision maker should consider the possibility of making adjustments in the determination of the risk assessments, as long as the decision maker is aware of the uncertainty caused by the presence of unforeseen contingencies.²²⁹⁰ For instance, even if some events, such as a change of regime in the context of a state contract, have not been specifically contemplated by the parties in a given case, the parties may have both contemplated and allocated the relevant risk, not specifically, in its narrow frame, but as part of a broader risk, such as the state party's unilateral right to terminate the contract on the basis of its discretion. The decision maker may account for the incompleteness in the specification of the risks explicitly allocated by the parties in their narrow frame by adjusting the probability assessment of the more broadly framed risk on the basis of the test of reasonable persons of the same kind as the parties placed under the same circumstances. Although the broader risks are admittedly more uncertain because of the failure to specify all the relevant contingencies, these risks can nevertheless be priced, allocated and managed by the parties in their bargain in broader frames.²²⁹¹ Thus, the question is not whether a risk is allocated in a contract, but at what level it is allocated.²²⁹²

In ICC Case No 7365, the tribunal did not consider initially whether it should make adjustments in the determination of the risk assessments, but directly relied on a principle it derived from the UNIDROIT Principles and the Questech case, which, according to the tribunal, allowed it to adjust the contract due to unforeseen fundamental change of circumstances in the particular context of the contract.²²⁹³ The case concerned two contracts for the sale ("Sales Contract") and for the installation ("Service Contract") of sophisticated military equipment that comprised an Air Combat Maneuvering Range ("System"), which was entered into in 1977 between a United States corporation (Cubic) and the Iranian Air Force (Iran). Under the Sales Contract, Iran was provisionally to accept and take delivery of the System at Cubic's plant in San Diego, California and subsequently transport the System to Iran. Under the Service Contract, Cubic was to perform various site preparation tasks prior to formal acceptance in Iran and thereafter to perform installation, maintenance and training in connection with the equipment for a specified period of almost three years. The contracts were duly performed until the advent of the Islamic Revolution in early 1979 and Iran had paid 70% of the price due under the Sales Contract, i.e. the down payment of 50% and two payments of 10% each relating to Cubic's partial performance identified as "Milestone 1" and "Milestone 2".²²⁹⁴ The parties entered into a series of negotiations but were unable to reach an agreement as to how to proceed in the context of revolution. Iran argued that, because of Cubic's breach of the Service Contract by evacuating its specialists from Iran and also for reasons of force majeure and frustration, it could not pay and was prevented from making the

²²⁹⁰ Triantis, George, Contractual Allocations of Unknown Risks: A Critique of the Doctrine of Commercial Impracticability, *University of Toronto Law Journal*, 42-4 (1992), at 467

²²⁹¹ *Ibid.*, at 468

²²⁹² *Ibid.*, at 483

²²⁹³ ICC Award in Case No. 7365, May 5, 1997, *Islamic Republic of Iran vs. Cubic Defense Systems, Inc.*, published in excerpts in ICC International Court of Arbitration Bulletin, 15-2 (2004), at 108 and *Uniform Law Review* (1999-3), at 796. Reference will be made to the original version of the award, available to the author, which is more complete than the published excerpts.

²²⁹⁴ *Ibid.*, at para. 9.3

payments corresponding to "Milestone 3" under the Sales Contract.²²⁹⁵ Iran claimed the reimbursement of payments made to Cubic in addition to damages, while Cubic argued that Iran had breached its contractual obligations by not paying the remainder of the price, and presented a counterclaim for damages. The contracts contained a choice of law clause designating the law of Iran.²²⁹⁶ Even so, the arbitral tribunal stated that "both Parties eventually agreed to the complementary and supplementary application of general principles of international law and trade usages... As to the contents of such rules, the Tribunal shall be guided by the Principles of International Commercial Contracts, published in 1994 by the UNIDROIT Institute, Rome."²²⁹⁷

The tribunal noted that "The revolutionary events ... occurred and even culminated precisely during the period when the performance of the Sales Contract entered into the milestone 3 phase, which was defined as completion of subsystem tests at Cubic's plant and acceptance of same by Iran's representatives; following this step, the System should have been shipped - under an U.S. export licence - to Iran. Not surprisingly, the performance of milestone 3 was disturbed as a result of the chaotic situation during the revolutionary period... The System has not been shipped to Iran."²²⁹⁸ It was disputed between the parties whether Cubic would have been able to ship the System to Iran in the period up to May 16, 1979, when the export licence was still valid in its original amount or whether the U.S. State Department would have cancelled the licence if it had been advised that the goods were to be shipped to Iran. While not answering this question, the tribunal noted that that "a certain risk of export licence cancellation existed at this time since even prior to the revolution of February 1979 some export licences were cancelled and even shipment of goods with export licences already in freight forwarding storage facilities were prevented. Cubic, as a company with particular know-how in the exportation of sensitive military equipment, must have been aware of such risk." The tribunal also stated that "[Cubic] must have been aware that the original licence had expired on May 16, 1979, and that the political situation was extremely unfavourable for the export of sensitive military equipment to Iran. Cubic must also have been aware of the reimbursement obligation it had under the Sales Contract... This explains why [Cubic] - keeping in mind that it was its responsibility to obtain and maintain the export licence - must have been interested in conducting negotiations with [Iran] in order to find a mutual solution to the problem of the Contracts."²²⁹⁹

The tribunal then underlined the importance of the principle of sanctity of contracts in the order of international commerce. It stated that "Legal certainty and stability require that a party to a contract is responsible for its performance. This traditional rule of contract law is known as sanctity of contract or "pacta sunt servanda", and is generally respected in all legal systems of the world. In principle it states that the parties must adhere to the terms of their contract and therefore be excused from non-performance only to the extent such is provided for in the contract. As a consequence, parties to a long-term contract are expected to foresee to a reasonable extent the developments, including changes, which may occur." Subsequently, the tribunal referred to the *clausula rebus sic stantibus*. It stated that "Under the laws of contract in all municipal legal systems exceptions to the basic notion of pacta sunt servanda

²²⁹⁵ Ibid., at para. 5.1

²²⁹⁶ Ibid., at para. 7.1

²²⁹⁷ Ibid., at para. 7.3

²²⁹⁸ Ibid., at para. 8.5

²²⁹⁹ Ibid., at para. 8.8

have been developed on the ground that in particular circumstances fairness and justice require the making of a legal excuse for nonperformance of contractual promises. While the excuse concepts in different legal systems vary to a great extent, they are all based on largely the same premise; namely, that some unforeseen development has occurred [sic] affecting the contractual performance without the fault and beyond the control of the parties. For instance, Subsec. 4 of the UNIDROIT Principles Art. 6.2.3 setting out the legal consequences of hardship states that "If the court finds hardship it may, if reasonable (a) terminate the contract at a date and on terms to be fixed, or (b) adapt the contract with a view to restoring its equilibrium." Moreover, from the covenant of good faith and fair dealing which is implied in each contract follows that in a case in which the circumstances to a contract undergo said fundamental changes in an unforeseeable way, a party is precluded from invoking the binding effect of the contract. The idea that a change in circumstances may affect the binding force of a contract is known under the maxim *clausula rebus sic stantibus*: the contract remains binding provided that things remain unchanged. It is understood, however, that due to the fundamental principle of *pacta sunt servanda* not any change of circumstances can be sufficient. Due to its exceptional character, its application is only justified if the change in circumstances was fundamental and unforeseeable. In such restrictive and narrow form this concept has been incorporated into so many legal systems that it is widely regarded a general principle of law. As such, it would be applicable in the instant arbitration even if it did not form part of the Iranian law.²³⁰⁰

The tribunal referred to the practice of the Iran-U.S. Claims Tribunal, which refused to apply the doctrine of changed circumstances to contracts the termination of which was invoked by the Iranian party as a result of the political change caused by the Islamic Revolution, due to its general position that the revolutionary changes per se did not constitute an unforeseeable change of circumstances which could excuse Iran from non-performance of any commercial contract entered into with the United States prior to the beginning of the revolution.²³⁰¹ However, according to the tribunal, all of the awards rejecting the applicability of the doctrine of changed circumstances did not involve the national security of Iran but the oil industry. The tribunal referred to the Questech award, which in its view, expressly distinguished between the case of sales of highly sensitive military equipment from cases involving "ordinary commercial relations".²³⁰² The tribunal stated that "In this situation which was characterised by the transfer of sensitive military equipment from one country to the other, the political relationship between the countries concerned was of utmost importance. Such relationship had worsened in spring 1979 to an extent that it had become highly improbable that Cubic would obtain, after the expiration of its original export licence, an unrestricted renewal."²³⁰³

Thus, the tribunal held that "(i) regardless of whether [Iran] was objectively still capable - despite the revolutionary turmoil in its home country - to make payment through a representative in the U.S.A. when Milestone 3 was completed and (ii) regardless of whether the Parties were actually aware of the quasi-cancellation of the needed export license, the fulfillment of the Contracts was undoubtedly on the verge of being frustrated due to the changed political relationship between the countries... Applying the principles referred to in

²³⁰⁰ Ibid., at para. 8.10

²³⁰¹ Ibid., at para. 8.14

²³⁰² Ibid., at para. 8.15

²³⁰³ Ibid., at para. 8.17

the Questech case ... *mutatis mutandis*, the Arbitral Tribunal concludes that the fundamental change of circumstances entitled each of the Parties to unilaterally request, if not the termination of the contracts, then at least an adaptation of its terms, in particular the postponement of the contractual dates by a reasonable period of time.”²³⁰⁴

The examination of the issue of hardship under *lex mercatoria* should not start from the pre-established models of risk allocation, which would derive from the application of the default mechanisms of force majeure or hardship. In international contracting practices, the parties negotiating a contract should be expected to have begun with an assessment as complete as possible of all the specific and broader risks of their contract, before resorting to such mechanisms that can be found in the model clauses or default rules of force majeure, hardship, frustration or impracticability, which allow the decision maker to address the residual allocation of the relevant risks. Thus, even if the specific allocation of risks do not readily provide a solution for the particular dispute, the decision maker applying *lex mercatoria*, rather than seeking such a solution in those default mechanisms, should consider the possibility of dealing with the incompleteness in the specific allocation of the risks by adjusting the probability assessment of the more broadly framed risk on the basis of the test of reasonable persons of the same kind as the parties placed under the same circumstances. In ICC Case No 7365, since the tribunal proceeded from Article 6.2.3 of the UNIDROIT Principles, in its approach to the issue of hardship, the tribunal’s considerations of the nature of the contract and the effect of changed circumstances on the obligations in its particular context apparently served the tribunal’s examination of whether they justify a possible adaptation of the contract, in terms of the postponement of the contractual dates by a reasonable period of time. However, the tribunal might have given effect to the reasonable expectations of the parties in a more accurate manner, whereby the solution could have emerged in line with the basic principles of the order of international commerce, had those considerations be initially taken into account by the tribunal for the purpose of making adjustments in the determination of the risk assessments, as in the decision in the Qeustech case, rather than for justifying directly an adjustment in the contractual terms on the basis of a solution, which is suggested by the UNIDROIT Principles as a pre-established model that cannot be considered as the established one in the order of international commerce.

Despite its conclusion with regard to the change of circumstances and the applicability of Article 6.2.3 of the UNIDROIT Principles, the tribunal in ICC Case No 7365 arrived at a solution similar to the one in the Questech award and implicitly made adjustments in the determination of the risk assessments. On the basis of the evidence of negotiations and the subsequent conduct of the parties, the tribunal found that the parties agreed in 1979 to discontinue the contracts until the results of Cubic’s attempt to resell the System would be known.²³⁰⁵ While Iran concentrated its claims on the reimbursement of its advance payments, Cubic partly reused the System manufactured for Iran mainly in the context of a sale to the Canadian Government and was then no longer in a position or willing to perform the Contracts. The tribunal held that this situation amounted to a factual termination of the contracts at the request of Iran.²³⁰⁶ In fact, the contracts explicitly provided for the right of Iran to terminate for its convenience, by written notice, the contract in whole or in part “when it is in the best interest of the Government”. The amounts to be paid by Iran to Cubic by

²³⁰⁴ Ibid., at para. 8.18

²³⁰⁵ Ibid., at para. 10.11

²³⁰⁶ Ibid., at para. 11.21-11.22

reason of termination under this clause "may include a reasonable allowance for profit on work done."²³⁰⁷

However, it was doubtful whether this clause could be directly applied to the case. The tribunal stated that it is a widely accepted principle that contractual obligations of the parties may be implicit and in this respect referred to Articles 5.1 and 5.2 of the UNIDROIT Principles in considering that "Implied obligations may stem from the nature and purpose of the contract, practices established between the parties and usages, good faith and fair dealing and reasonableness".²³⁰⁸ According to the tribunal, pursuant to such criteria as good faith and fair dealing, parties to a contract may reasonably expect that similar situations should have the same or similar consequences to the extent that the applicable law or the contractual terms do not explicitly provide otherwise, and in the instant case, the factual circumstances were extremely close to, if not identical with, a termination of the Contracts by Iran for its convenience. In this regard, the tribunal again turned to the risk assessments of the parties and considered that it was mainly Iran which expressed the wish to terminate the contracts, whereas Cubic would obviously have preferred that the project be continued subject to the timely renewal of the export licence and the change of circumstances that induced the parties to discontinue the Contracts, i.e. the Islamic Revolution, occurred in Iran's, not in Cubic's area of risks.²³⁰⁹ The tribunal then stated that "Except for the absence of an explicit reference, by Iran, to the Termination for Convenience Clause or to a similar language close to the wording of that contractual provision, all requirements of a contract termination under the Termination for Convenience Clause are met. It would be excessively formalistic, and contrary to the principles of good faith, fair dealing and reasonableness if Iran's entitlement to a reimbursement of the advance payments and Cubic's entitlement to further payments would be governed, in the instant case, by different legal or contractual provisions than in the event Iran had formally invoked the contract clause entitling it to terminate the Contracts for its convenience. Accordingly, the Tribunal concludes that the Termination for Convenience Clause shall be applied, if not directly, then at least by analogy, to the assessment of the Parties respective claims."²³¹⁰

The tribunal stated that "The obvious and most important effect of a contract termination, be it for the convenience of one party or for other reasons, is that either party may claim restitution of whatever it has supplied, provided that such party concurrently makes restitution of whatever it has received" (UNIDROIT Principles Art. 7.3.6). The same principle applies under Iranian law in the event of mutual termination of a contract.... The principle is explicitly referred to in the Termination for Convenience Clause which provides for a refund of payments by the contractor should the contractor's statement of expended funds show excess payments by Iran".²³¹¹ Under the termination for convenience clause, the amount to be taken into account in favour of Cubic consisted of a compensation for Cubic's "expended funds" that related to Cubic's direct costs and "a reasonable allowance for profit on work done" as an allowance for Cubic's gross profit margin, which covered Cubic's general and administrative expenses, its research and development costs as well as its net profits, but not

²³⁰⁷ Ibid., at para. 11.23

²³⁰⁸ Ibid., at para. 11.25

²³⁰⁹ Ibid., at para. 11.26

²³¹⁰ Ibid., at para. 11.27

²³¹¹ Ibid., at para. 13.1

lost profits on work not already done.²³¹² Moreover, the tribunal considered that since the hardware manufactured by Cubic remained at Cubic's disposal, its entitlement to be compensated was reduced by the value of resale or reuse of the System.²³¹³ In the end, Iran was awarded with compensation since it had already made payments under the Sale Contract in excess of the amount of compensation to which Cubic was entitled under the Sales Contract, and no additional claims was awarded under the Service Contract.²³¹⁴

In other cases, the arbitral tribunals rejected the application of hardship rules in the UNIDROIT Principles as a pre-established model for verification of trade usages in the narrow sense, or general principles of law. In ICC Case No. 8873, which concerned a construction contract governed by Spanish law pursuant to the choice of law of the parties, the contractor argued that the dispute should be decided not only on the basis of the provisions of Spanish law, but taking into account the international trade usages and the general principles of law and, in particular, practices existing in the field of international civil engineering contracts. The contractor invoked the hardship rules under Articles 6.2.2 and 6.2.3 of the UNIDROIT Principles, due to a number of unforeseen difficulties which substantially increased the cost of the construction. The tribunal stated that, as the parties chose Spanish law as the governing law of the contract, the contractor was required to prove that the hardship provisions of the UNIDROIT Principles reflect a generally established international practice, where those involved in international trade consider themselves bound without the need for an express stipulation to that effect. The arbitral tribunal considered that, although there is a tendency to stipulate hardship clauses in certain sectors of international trade in a repetitive way and it is possible to consider the provisions of UNIDROIT Principles on hardship as commercially reasonable, the hardship clauses in business practice deal with a principle of exceptional matters and, thus, determine, in detail, the circumstances justifying the hardship and its consequences. In the tribunal's view, since the contents of the hardship clauses in international practice vary greatly in different contractual settings, the hardship provisions of the UNIDROIT Principles cannot be considered as trade usages in the narrow sense, in the absence of explicit reference by the parties.²³¹⁵

In ICC Case No. 9029 which concerned a Shareholders Agreement for the financing of an aeronautical project between an Italian company and an Austrian company, the respondent claimed that the agreement was invalid or inapplicable, and based its claims on the UNIDROIT Principles, particularly, among others, the provisions on hardship, as "as an authoritative source of knowledge of international trade usages".²³¹⁶ The agreement contained a choice of law clause in favor of Italian law as the applicable law. The respondent argued that the agreement caused grave hardship to the detriment of the respondent due to the excessive disparity in the contract or in some of its clauses, with excessive advantage to one of the parties, and particularly maintained that the services rendered by the claimant were no more than abstract "Supports", in part not corresponding to the truth and in part, on the contrary, laying burdens exclusively on the respondent.²³¹⁷ The arbitral tribunal considered

²³¹² Ibid., at para. 13.2-13.4

²³¹³ Ibid., at para. 13.8

²³¹⁴ Ibid., at para. 18.1-18.2

²³¹⁵ ICC Award in Case No. 8873, July 1997, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 80

²³¹⁶ ICC Award in Case No. 9029, March 1998, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 88

²³¹⁷ Ibid., at 89

that the reference to *lex mercatoria* and the specific appeals to the UNIDROIT Principles did not constitute sufficient justification for sustaining the respondent's claim that the shareholders agreement should be declared invalid or void, for various reasons. First, the respondent failed to prove that the rules invoked are part of *lex mercatoria* and the existence of interpretative and applicative trends in international commercial circles supporting the interpretation that was put forward. The tribunal stated that "although the Unidroit Principles constitute a set of rules theoretically appropriate to prefigure the future *lex mercatoria* should international commercial practice adapt to the Principles, at present there is no necessary connection between the individual Principles and the rules of the *lex mercatoria*, so that recourse to the Principles is not purely and simply the same as recourse to an actually existing international commercial usage."²³¹⁸ Secondly, according to the tribunal, "when the parties have chosen national law as the law applicable to their relationship, it being certainly not possible, in such a case, to substitute international commercial usages for the national law chosen by the parties with regard to institutions, actions, and effects, for which the latter makes special provision."²³¹⁹ Thus, the tribunal considered, as part of the articulated rules and the bargain, the relevant rules of Italian law, which specifically regulate the issues relevant to the dispute.

In any event, the tribunal considered that even if *lex mercatoria* and the UNIDROIT Principles were applicable in this case, the respondent's claim aimed at obtaining from the tribunal the finding that the shareholders agreement was invalid or void, could not be sustained with regard to the supposed hardship. The tribunal stated that "the extent of the contributions requested could reasonably have been foreseen by a professional operator in the aeronautical sector, by exercising the due diligence expected from a professional from the sector to which Respondent belonged."²³²⁰ According to the tribunal, in the case, there would be no presuppositions of hardship that were listed under Article 6.2.2 (a)-(d) of the UNIDROIT Principles and, therefore, no grounds for a finding of invalidity or nullity. In this regard, the tribunal noted that "Respondent was aware - or, at any rate could have been aware, ... that this was an old project, and that responsibility for the technical aspects, the certification, the marketing, and any finance necessary for the joint venture would fall upon it, and that it would assume the related risk; that no unforeseen circumstances had even emerged while the contract was being concluded such as to aggravate that risk, taking into account, after all, that Respondent declared its intention of extricating itself from its obligation only two months after the Shareholders Agreement had been finalized."²³²¹

Under *lex mercatoria*, the traditional concept of hardship should be replaced by a notion of risk allocation, which does not follow solely the default mechanisms of the relevant doctrines, but considers the context and nature of the particular contract. This is essentially reflected by the UNIDROIT Principles, which provide in Article 6.2.2 sub-paragraph (d) that there can be no hardship if the risk of the events was assumed by the disadvantaged party.²³²² The risks associated with the relevant hardship event may be allocated implicitly as inferred from other terms of the contract or on the basis of the test of reasonable persons of the same kind as the

²³¹⁸ Ibid., at 90

²³¹⁹ Ibid., at 91

²³²⁰ Ibid., at 92

²³²¹ Ibid., at 93

²³²² The same requirement is also mentioned in Article 6:111 (2) (c) of the PECL which states that there can be no hardship if "the risk of the change of circumstances is not one which, according to the contract, the party affected should be required to bear."

parties placed under the same circumstances. In practice, rather than referring to pre-established models, the parties negotiate a suitable risk allocation aimed at establishing which party should bear which risk.²³²³ In line with this practice, the decision maker should exercise his abstract reasoning in determining the foresight of the parties as to their awareness of the risks such transaction present and in making adjustments in their probability assessments.

In an arbitral case before the Centro de Arbitraje de México in 2006, the arbitral tribunal rejected the defense of hardship due to the risk allocation between the parties by referring to Article 6.2.2 sub-paragraph (d) of the UNIDROIT Principles. In the case, the claimant asked for termination of the contract as well as damages for the harm suffered as a result of the respondent's failure to provide the goods. The parties expressly referred to the UNIDROIT Principles as the law governing the substance of any potential disputes. The respondent objected that its failure to deliver the goods was due to the destruction of the crops by a series of extraordinarily heavy rainstorms and flooding caused by the meteorological phenomenon known as "El Niño". According to the respondent these events amounted to a case of hardship and therefore any liability on its part was excluded. The tribunal examined the case in light of Article 6.2.2 of the UNIDROIT Principles. The tribunal considered that the occurrence of "El Niño" fundamentally altered the equilibrium of the contract because it affected the supply of products dramatically. According to the tribunal, the weather event was unpredictable at the time of contracting and beyond the control of the respondent. However, the tribunal found that the respondent assumed the risk. In the tribunal's view, the reason for the parties to enter into a supply contract is twofold: the supplier wishes to ensure a buyer, and the buyer wishes to ensure the desired volume of available supply. According to the tribunal, in this understanding, the supply contract, in essence, regulates the risk whereby the supplier does not have to worry about the market situation, because that risk is now borne by the buyer, who is committed to purchase a given volume, and the buyer does not have to worry about the existence of the product, because the risk is borne by the supplier, who is committed to make available a certain volume of the product. Accordingly, the risk of the occurrence of an event that affects the production lies with the producer and a decline in demand for the product on the market is not a reason for the buyer not to perform its obligation to pay for the product supplied by the supplier. Thus, tribunal rejected the respondent's argument that its liability for non-performance was excluded on the grounds of hardship, by holding that, especially in the context of a supply agreement concerning specific quantities of goods to be delivered, a vegetable grower assumes the risk of crop destruction by rainstorms and flooding.²³²⁴

In ICC Case No. 8486, a Dutch manufacturer and Turkish buyer concluded a contract for the installation of a machine for the production of lump sugar for the Turkish market. The contract provided Dutch law as the applicable law. The agreed price was for the entire installation, and the buyer had to pay 5% of the price one year prior to delivery. Due to financial difficulties, the buyer only paid 3% of the contractual price as advance payment. Following unsuccessful negotiations, the manufacturer commenced ICC arbitration as provided for in the contract. The manufacturer claimed an amount in payment for the part of the manufacturing system which could not be sold to other buyers as it had been made expressly for the Turkish buyer as well as interest and legal fees. The buyer objected that it was discharged of its obligations under the contract because of the dramatic drop in the price

²³²³ Draetta, Ugo, Force Majeure Clauses in International Trade Practice, *International Business Law Journal*, (1996), at 358

²³²⁴ Centro de Arbitraje de México (CAM), Award dated 30 November 2006, available at <http://www.unilex.info/case.cfm?id=1149>

of the relevant product on the Turkish market, which amounted to hardship. The buyers also counterclaimed its advance payment.²³²⁵

The sole arbitrator considered that the circumstances alleged by the defendant did not discharge the defendant from its obligation to pay on the ground of unforeseen circumstances in the sense of Article 6:258 of the Dutch Civil Code. The arbitrator started from the premise that Article 6:258 must be applied with the utmost restraint because, among others, it is a special rule with respect to the general possibility, under Article 6:248(2) together with Article 3:12 of the Dutch Civil Code, to consider certain contractual provisions inapplicable on grounds of reasonableness and fairness in certain circumstances.²³²⁶ The arbitrator noted that “In Dutch national legal practice, the general provision [of Art. 6:248 BW] is applied with the utmost restraint... According to Art. 3:12 BW, 'Dutch common opinion of law' is the determining factor in the first place; it is replaced by the common opinion in international contract law when the provision is applied in an international context. Both are influenced in a decisive manner by the principle of contractual good faith (*pacta sunt servanda*) expressed in Art. 1.3 of the UNIDROIT Principles for International Commercial Contracts... This common opinion of law must also be taken into account for the application of national law to international relationships... The necessity and admissibility of the interpretation of national law in the light of the UNIDROIT Principles is also asserted especially for Dutch law... The same restraint should be exercised, according to the Dutch legislator, when applying the special provision of Art. 6:258... This restraint is also in line with international contractual and arbitral practice. It is also to be taken into consideration in the context of Dutch national law.”²³²⁷

According to the arbitrator, “the termination of a contract for unforeseen circumstances ('hardship', '*clausula rebus sic stantibus*') should be allowed only in truly exceptional cases”. The arbitrator considered the following in exercising his abstract reasoning: “In international commerce one must rather assume in principle that the parties take the risks of performing under and carrying out the contract upon themselves, unless a different allocation of risk is expressly provided for in the contract... Art. 6.2.1 of the UNIDROIT Principles expressly provides that the mere fact that the performance of the contract entails a higher economic burden for one of the parties does not suffice to assume that there is 'hardship'... Also the ICC Principles on 'Force Majeure and Hardship' provide that a party cannot argue that performance is impossible only because the contract happens to have become unprofitable Accordingly, a Dutch arbitral tribunal held that a dramatic fall in the price [of a product] as well as currency fluctuations alone are not unforeseen circumstances and thus do not justify the termination of a contract. In the opinion of the arbitral tribunal, these circumstances fall rather within the risk sphere of the party concerned”.²³²⁸

Applying this reasoning to the case, the arbitrator found that “The rising of a private manufacturing sector and the connected fall in the price [of the product] described therein, as well as the general trade situation in Turkey, only concern the economic frame of the Turkish market and thus fall within the risk sphere of the defendant.”²³²⁹ This finding was supported

²³²⁵ ICC Award in Case No. 8486 (1996), *Yearbook Commercial Arbitration*, (1999), at 163-164

²³²⁶ *Ibid.*, at 165

²³²⁷ *Ibid.*, at 166-167

²³²⁸ *Ibid.*, at 167-168

²³²⁹ *Ibid.*, at 168

by the submissions of the defendant that “it was perfectly aware of the unstable commercial situation in Turkey and that it always had to consider that 'the situation ... can change suddenly'.” The arbitrator also considered that “With respect to these unstable circumstances on the Turkish market, which were known to the defendant, it does not seem maintainable that the defendant wants to shift the commercial risks related thereto onto the claimant. Further, the claimant helped the defendant when concluding the contract, in that by [accepting] the financing clause [contained therein] it accepted a significant pre-financing risk, apparently in consideration of the good commercial relations which had existed until then between the parties. Also, during the entire proceedings the claimant has indicated its willingness to cooperate in an economic solution of the problem which is acceptable for the defendant.” The arbitrator concluded that “In the light of the above situation, the circumstances raised by the defendant fall within the economic risk to be borne by the defendant, also according to the interpretation valid in international commercial relations. The arbitral tribunal may not, according to Art. 6:258(2) BW, consider them unforeseen circumstances in the sense of this provision”.²³³⁰

Only the failures of the parties to contemplate and allocate the risks of change of circumstances, which represent a gap of risk allocation in the articulated rules that cannot be addressed, by means of a contextual interpretation and adjustments in the determination of the risk assessments, should trigger the considerations of hardship under *lex mercatoria*. In ICC Case No. 1512, the arbitrator stated that “The principle “*Rebus sic stantibus*” is universally considered as being of strict and narrow interpretation, as a dangerous exception to the principle of sanctity of contracts. Whatever opinion or interpretation lawyers of different countries may have about the 'concept' of changed circumstances as an excuse for nonperformance, they will doubtless agree on the necessity to limit the application of the so-called 'doctrine *rebus sic stantibus*' (sometimes referred to as 'frustration', 'force majeure', 'Imprévision', and the like) to cases where compelling reasons justify it, having regard not only to the fundamental character of the changes, but also to the particular type of the contract involved, to the requirements of fairness and equity and to all circumstances of the case... As a general rule, one should be particularly reluctant to accept it when there is no gap or lacuna in the contract and when the intent of the parties has been clearly expressed... Caution is especially called for, moreover, in international transactions where it is generally much less likely that the parties have been unaware of the risk of a remote contingency or unable to formulate it precisely”.²³³¹

b. Renegotiation

In the first instance, the hardship situations under *lex mercatoria* should lead the decision maker to consider the renegotiation of the agreement by the parties with a view to adapting the contract or terminating it thereby enabling them to arrive at the allocation had they contemplated and allocated the relevant risks at the time of contracting. As it is pointed out, finding alternative contractual terms which reasonably allow for the consequences of the hardship event is a complex endeavor best carried out by the parties themselves.²³³² In ICC Case No 2291, the arbitrator, applying *lex mercatoria*, stated that any commercial transaction is founded on the balance of reciprocal performances and that to deny such principle would

²³³⁰ Ibid., at 169

²³³¹ ICC Award in Case No 1512, 1971, Yearbook Commercial Arbitration, (1976), at 129

²³³² Brunner, Christoph, Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration, Kluwer Law International, 2009, at 480

transform a commercial transaction into a hazardous and speculative contract. According to the arbitrator, it is a rule of *lex mercatoria* that the performances are balanced in financial terms.²³³³ The arbitrator considered that as the contract must be interpreted in good faith, each party has the duty to behave in a manner that avoids causing prejudice to the other party, while the reasonable renegotiation being customary in international economic transactions.²³³⁴

In some cases, the parties explicitly provide in the contract a duty to renegotiate in the change of circumstances. In those cases, the decision maker should analyze the scope and consequences of its application. In ICC case No. 2478, the arbitral tribunal had to rule on a claim for damages made by a French company against a Rumanian company which had not delivered to it a certain quantity of fuel because of a change in the price of oil. The respondent maintained that its refusal to deliver the oil was justified and relied on Appendix 3 to the contract, which contained a clause that “In the event of devaluation or revaluation of the French franc or the dollar, the parties shall come together to examine the consequences of the new situation and agree on the measures to be taken in order to reestablish the contractual equilibrium as intended by and in the initial spirit of the contract for the as yet undelivered quantities as well as for the as yet unpaid quantities”. The respondent argued that this clause was to be interpreted as a clause of 'unforeseeability or monetary parity' and it placed the parties under an obligation to adjust the prices when the contract's initial conditions had undergone a change and, as the negotiations entered into by the parties following the devaluation of the dollar proved to be abortive, the contract had lost its reciprocal nature and no longer needed to be performed. The arbitral tribunal noted that “Appendix 3 to the contract actually constitutes only an obligation to negotiate in view of agreeing on measures to be taken in order to re-establish a contractual equilibrium in the event that the French franc or the U.S. dollar (the contract currencies) would be devalued or revaluated.” According to the tribunal, the movement of prices on the world oil market as such was not covered by that clause, which was not a price revision clause. Moreover, the tribunal stated that “Appendix 3 does not automatically entitle the parties to the cancellation of the contract should the negotiations fail. The respondent could certainly have had recourse to arbitration had it considered that the other party's refusal to accept the new price offered by the respondent was unjustified. But as long as the arbitral award, which would be favorable to it, had not been made, nothing in Appendix 3 authorized the respondent to suspend unilaterally the deliveries provided in the contract.”²³³⁵

In ICC Cases No 6515 and 6516, which were joined by the same arbitral tribunal, the parties entered into a number of agreements which were intended to associate the Italian claimant with the development of a major project to be undertaken in Greece by two Greek defendants. The defendants were to compensate the claimant for services rendered under the agreements. The understanding of the parties was that the compensation paid by the defendants to the claimant was not subject to Greek taxes since the claimant did not have a permanent establishment in Greece and the compensation was subject to Italian taxes by reason of the Tax Treaty between Italy and Greece. The Greek authorities decided that the claimant had acquired a permanent establishment in Greece and the compensation should be subject to the withholding tax. This decision resulted in double taxation as the claimant already bore Italian

²³³³ ICC Award in Case No. 2291, *Journal du Droit International*, (1976), at 989

²³³⁴ *Ibid.*, at 990

²³³⁵ ICC Award in Case No. 2478, *Yearbook Commercial Arbitration*, (1978), at 222 et seq.

corporate income taxes in Italy for those payments. The claimant argued that the burden of these withholdings should be borne by the defendants. The contract provided that the parties should negotiate in good faith in case of the changed circumstances. The tribunal, in a majority decision, held that the defendants' failure to negotiate had damaged the claimant and awarded claimant damages amounting to 65% of the Greek tax liability.²³³⁶ This decision is a clear case of splitting the difference as far as its section on the measure of damages is concerned.

The case is also interesting due to the approach of the tribunal to the issue of change of circumstances. Although the imposition of the withholding tax did not result in any excessive hardship for the claimant within the meaning of Article 388 of the Greek Civil Code, which was chosen as applicable by the parties, the tribunal considered the requirements of Article 388 as irrelevant in the particular circumstances of the case. The tribunal stated that "the parties did not anticipate, [at the time of contracting], that Greek tax law would be interpreted and applied so as to impose a 20% or 25% withholding on payments made by either first or second defendant to claimant. Accordingly, the parties based their business analysis on the assumption that *no* corporate income tax was exigible [in] Greece, and that *no* corporate income tax would be exigible in Greece. This assumption proved wrong." The tribunal considered whether disruption of the economic balance of the contracts which resulted from the imposition of withholdings should be taken into account. The tribunal stated that "the parties did agree upon an *initial* allocation of the taxes as between themselves, because this *initial* allocation worked out an economic balance which was satisfactory to all of them. But they never said that this initial allocation should be maintained at all costs, including the cost of disruption of the economic balance of the contracts.... The initial allocation of taxes provided by the contracts was to remain unchanged *rebus sic stantibus*. But changes in economic circumstances certainly could warrant re-allocation of taxes between the parties. They certainly indicated that the parties make a bona fide effort in order to reach an agreement with that re-allocation of taxes. The arbitral tribunal does not harbor any doubt that the imposition of the withholdings on the compensation paid by the first and/or second defendant to claimant constituted such a change in economic circumstances.... the contracts were based upon an analysis of the economic profitability of the underlying transactions. That analysis led the parties to agree upon the initial allocation of taxes. Thus, this initial allocation of taxes was one of the elements which the parties took into account in order to work out their agreement. It may well be that the imposition of the withholdings did not result in any excessive hardship for claimant – a highly doubtful conclusion in light of the facts that (i) profit margins are usually low in such a competitive environment as engineering, and that (ii) those profit margins were flattened out by double taxation. But whether the imposition of the withholdings resulted or did not result in excessive hardship within the meaning of Art. 388 of the Greek Civil Code is totally irrelevant here, since the parties had agreed that, in any case, they would enter into a bona fide attempt at settling the financial consequences thereof."²³³⁷

The tribunal interpreted the amendment clauses in the agreements to the effect that when the change of circumstances has an impact on the balance of contractual obligations, the parties are obliged to enter into bona fide negotiations in order to determine, which waivers, alterations or modifications would be necessary in order to strike a new balance between the obligations of the parties. The tribunal stated that "This is not to say, however, that the parties had an obligation to reach agreement on the proposed waivers, alterations or modifications.

²³³⁶ ICC Final Award in Cases No. 6515 and 6516, 1994, Yearbook Commercial Arbitration, (1999), at 80-81

²³³⁷ Ibid., at 95-96

The parties were left to agree or not to agree upon such waivers, alterations or modifications. But what they could not possibly escape was the obligation to listen to proposals which were put by one party to the other party.” According to the tribunal, this obligation to renegotiate in good faith would be binding upon the parties even if this was not explicitly stipulated in the agreement. However, the tribunal made it clear that “In so holding, the arbitral tribunal does not rest upon some freshly discovered principle of international trade law. It rests upon the very wording of Arts. 288 [on the principle of good faith] and 388 [on the change of circumstances] in the Greek Civil Code, which have been cited by the parties in their written submission and oral presentations.”²³³⁸ The tribunal, thus, held that “the contract here under consideration *made it an obligation for the parties to re-negotiate their Agreements in case of change in circumstances* – an obligation which was totally consonant with Greek law, and namely Arts. 288 and 388 of the Greek Civil Code.”²³³⁹

The tribunal found that the defendants were in violation of their contractual obligations, under three respects. First, the defendants, pending the completion of the works, failed to take a clear and unambiguous position as to whether they would agree or would not agree to re-negotiate the contracts thereafter, and misled the claimant into believing that a re-allocation of taxes would take place once the performance would be completed. In the tribunal’s view, in light of the attitude of the defendants, the claimant chose to complete its share of the works, with no other warranty than what it believed was an implicit commitment by the defendants to enter into negotiations.²³⁴⁰ Secondly, the defendants, after completion of the works failed to enter into bona fide negotiations with the claimant for the purpose of determining whether the change in economic circumstances warranted a re-allocation of the tax burden as between the claimant and the defendants. According to the tribunal, since the proposals made by the claimant at this stage were never clearly approved or disapproved by the defendants, the claimant was again misled to believe that bona fide negotiations had taken place and that these bona fide negotiations had resulted into a firm agreement between the parties as to reallocation of taxes.²³⁴¹ Thirdly, the defendants, once the Greek authorities had started to impose the withholdings on the amounts paid to the claimant, failed to enter into bona fide negotiations in order to amicably settle their difference with the claimant, thereby forcing the claimant into arbitration. The tribunal found that the parties incorporated the ingredient of negotiation into the provisions of the jurisdictional clause, but the defendants did not respond to efforts of the claimant to initiate an amicable settlement and, even made “their best efforts in order to block any direct negotiation” between the claimant and the defendants.²³⁴²

In the case, the claimant requested monetary damages since the agreements were fully carried out. The defendants suggested that the claimant suffered no injury because notwithstanding the imposition of the withholdings, the claimant was able to fully carry out its obligations. However, according to the tribunal, the claimant suffered injury because its compensation was decreased by a significant percentage.²³⁴³ The claimant argued that it should be awarded the total amount of the withholdings. However, the tribunal considered that the damages must be somewhat lesser than the withholdings since, at the time the claimant made its first request to

²³³⁸ Ibid., at 97

²³³⁹ Ibid., at 98

²³⁴⁰ Ibid., at 101-102

²³⁴¹ Ibid., at 102

²³⁴² Ibid., at 99-100

²³⁴³ Ibid., at 103

the defendants with respect to re-allocation of the tax burden in its letter to the defendants, the claimant limited its claim to “a reasonable readjustment of contract price to compensate claimant of the financial consequences suffered” by reason of the withheld money.²³⁴⁴ On the basis of that letter, the tribunal stated that it “could have found that an even division between claimant and defendants of the total of money withheld ought to be made in order to fulfill the request which claimant made at that time for a ‘reasonable adjustment’.” However, in order to assess damages due and owing to the claimant, the tribunal also took into account the subsequent behavior of the defendants, which misled the claimant into believing that a reasonable adjustment would take place and whereby the claimant continued to perform in good faith before any clear understanding had been reached as between the parties with respect to the reasonable adjustment. The tribunal also took into consideration “the fact that the defendants did try some efforts, if not their best efforts, in order to have the Greek authorities withdraw their decision on the withholdings.”²³⁴⁵ On the basis of these considerations, the tribunal held that “the total amount of the moneys withheld should be split 35%-65%; and that 35% of the withholdings should be borne by claimant, whereas 65% of the withholdings should be borne by first and second defendants.”²³⁴⁶

In ICC Cases No. 6515 and 6516, the tribunal considered that there was a gap in the risk allocation agreed by the parties, since the parties did not contemplate and allocate the risk of the imposition of the withholding tax in Greece. The parties provided a contractual obligation of renegotiation for dealing with the gaps in their initial risk allocation. Thus, even if the withholding tax did not result in any excessive hardship for the claimant, the arbitral tribunal pointed out that the terms of the contract, which obliged the parties to negotiate in cases of gaps in the agreed risk allocation, should prevail over the default mechanisms provided by the applicable national rules. However, although the tribunal earlier in the award stated that the parties were not under an obligation to reach agreement on the proposed adjustments, it eventually imposed what was proposed by the claimant during negotiations upon the defendants. Moreover, since this proposal contained a vague reference to the concept of reasonableness, the tribunal imposing this solution inevitably arrived at a decision of splitting the difference on equitable grounds, even if it tried to justify its solution with the behavior of the defendants during negotiations. In cases of failure to perform the duty of negotiation, the decision maker should award damages for the expenses incurred by the aggrieved party in the negotiations, i.e. negative or reliance interest, but should not impose the imaginative outcome of a failed process of negotiation, which amounts to awarding compensation for speculative damages. In such cases, in order to be able to adapt the contract or award expectation or positive interest to the aggrieved party, the decision maker should either be authorized by the terms of the contract or applicable default rules to impose a reasonable solution, or find a correspondence of expectations of the parties during the process of negotiations, which allows him to ascertain and enforce the object of negotiations in an objective manner.

The tribunal’s exercise of adjustment and splitting the difference in this case seems inappropriate as it can be considered as an instance of equity contra legem. As stated in the Aminoil award, “there can be no doubt that a tribunal cannot substitute itself for the parties in order to make good a missing segment of their contractual relations- or to modify a contract –

²³⁴⁴ Ibid., at 104

²³⁴⁵ Ibid., at 105

²³⁴⁶ Ibid., at 106

unless that right is conferred upon it by law, or by the express consent of the parties.”²³⁴⁷ In ICC Cases No 6515 and 6516, the agreements did not provide for a reasonable readjustment by the tribunal in the change of circumstances, but merely required the parties to renegotiate in good faith. The parties did not regulate the consequences of a failure to reach an agreement, unlike some clauses in practice under which this issue is explicitly regulated, such as ICC Hardship Clause of 2003, which clearly provides for a right to terminate. In this regard, it is argued that in the event that the parties fail to agree under a renegotiation clause, which does not state the consequences of failure to agree, it must be presumed that they intended to authorize the competent court or arbitral tribunal to fill the gap and to adapt the contract so as to maintain its equilibrium.²³⁴⁸ Under this view, the legal consequences of renegotiation and hardship clauses are considered identical. However, this view neglects the established rule that the contractual duty to negotiate does not oblige the parties to agree. If the decision maker presumes that, as argued, the parties intended the decision maker to adapt the contract in case of failure to agree under a renegotiation clause, the decision maker would be compelled to impose on the parties an agreement which the parties were not obligated to enter into in the first place. Thus, the relevant clause should indicate the parties’ intentions as to the legal consequences of the occurrence of defined events. Thus, if a hardship clause merely obligates the parties to negotiate without regulating the failure of negotiations upon the occurrence of events that it defines by less stringent criteria than the requirements of the concept of hardship under the applicable default rules, it should be primarily treated as a negotiation clause, as the parties intended, and should not be interpreted in a way to relax the requirements of the hardship concept under the applicable default rules in order to enforce the legal consequences of the default hardship rules, unless there are other interpretative indications that reveal their common intention as to relaxing those requirements in that regard.

Thus, the tribunal in ICC Cases No 6515 and 6516 should have turned to the default mechanism provided by the national rules applicable in the case in order to devise a solution in the presence of the change of circumstances. Article 388 of the Greek Civil Code provides that “If having regard to the requirements of good faith and business usage, the circumstances on which the parties had mainly based the conclusion of a bilateral agreement have subsequently changed on exceptional grounds that could not have been foreseen and if because of this change the performance due by the debtor has become excessively onerous, taking also into consideration the counter-performance, the court may, at the request or the debtor, and according to its own discretion reduce the debtor's performance to the appropriate extent or determine the dissolution of the contract in its entirety or with regard to the part which has not been performed.”²³⁴⁹ The imposition of a 20% or 25% withholding on payments made by the defendants to the claimant the claimant seems not satisfactory for the requirement that the obligation should become excessively onerous, which would entitle the tribunal to adjust or terminate the agreement. The tribunal focused on the profit margins in the relevant sector, and it was of the opinion that this requirement could be satisfied in the case, but it did not rely clearly on Article 388, and even considered it “irrelevant” in reaching its conclusion.

²³⁴⁷ Ad-Hoc-Award, Kuwait v. The American Independent Oil Company (AMINOIL), International Legal Materials, 21 (1982), at 1015

²³⁴⁸ Brunner, Christoph, Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration, Kluwer Law International, 2009, at 514

²³⁴⁹ Zimmermann, Reinhard, & Simon Whittaker (eds.), Good faith in European Contract Law, Cambridge University Press, 2000, at 559

When there is no hardship clause in the individual contract, the arbitral tribunals in some cases held that there is a duty to renegotiate. Some authors have argued that the recognition and application of the duty to renegotiate represents neither the integration of universal principles nor a distillation of national legal rules, but the emergence of an innovative legal rule specifically designed for the needs and patterns of conduct in the community of international commercial merchants.²³⁵⁰ In ICC Case No 8365, the tribunal stated that it is one of the principles of *lex mercatoria* that if some unforeseeable difficulties emerge during the performance of a contract, the parties must in good faith renegotiate in order to overcome such difficulties.²³⁵¹ However, it is also argued that “At the transnational level there is by no means agreement on the existence of such a duty to renegotiate, even in light of the changing understanding of a contract as a flexible framework for the “fair” and “reasonable” distribution of contractual rights and obligations.”²³⁵² It can be observed that the arbitral tribunals in other cases implied a duty of renegotiation on the basis of the principle of good faith under the applicable national laws.

ICC Case No. 9994 concerned a licence and sales agreement between a US company and a French company, under which the former was to make, use and sell products derived from raw material supplied by the latter. The French company initiated the arbitration, claiming that the respondent wrongfully terminated the agreement, on the ground that it no longer corresponded to the respondent's business strategy, and unlawfully disclosed confidential information. The "law of France" was the substantive law to be applied to the dispute. The arbitral tribunal dismissed both claims of the claimant and found that the real reason for the respondent's withdrawal from the agreement was the increase in the price of the raw material and the parties' inability to agree on a new price. The price increase was due, amongst other things, to the more stringent conditions imposed upon the claimant by a government agency for the collection of human placentae from which the raw material was extracted. The tribunal stated that “French law requires from each party to perform the agreement in good faith (see c. civ. 1134, al. 2). Good faith imposes upon the parties the duty to seek out an adaptation of their agreement to the new circumstances which may have occurred after its execution, in order to ensure that its performance does not cause, especially when the contract at stake is a long term agreement, the ruin of one of the parties ... This principle is also prevailing in international commercial law (see *Unidroit Principles*, art. 6.2.2. and 6.2.3.).” The tribunal noted that “when negotiating the agreement, the parties were under the impression that the [government agency] would not impose a control placenta per placenta, although they did not exclude such an eventuality. Now, some time after the signature of the Agreement, the [government agency] required individual donors' screening and that severe demand was certainly one of the cause [sic] of the increase of the cost of the [raw material] well above the US\$. . . per gram agreed upon in the Agreement..., this was certainly a somehow unexpected event.” According to the tribunal, “the fact that the “Force Majeure Clause”, ..., did not expressly contemplate the risk of a potential regulatory change, does not “per se” exempt [Respondent] from renegotiating the contract price as, according to the French doctrine quoted thereabove, this duty is already imposed upon the contracting parties by the rule of good faith and that rule cannot be defeated by any divergent contractual provisions.” Thus,

²³⁵⁰ Carbonneau Thomas E., *A Definition of and Perspective upon the Lex Mercatoria Debate*, in Thomas E. Carbonneau (ed.), *Lex mercatoria and arbitration: a discussion of the new law merchant*, Kluwer Law International, Rev. ed., 1998, at 18

²³⁵¹ ICC Award in Case No. 8365, *Journal du Droit International*, (1997), at 1080

²³⁵² Berger, Klaus Peter, *Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators*, *Vanderbilt Journal of Transnational Law*, 36 (2003), at 1357

the tribunal held that due to the new request of the government agency relating to the control of the placenta, the claimant was entitled to a renegotiation of the contract price, but that did not mean at all that the claimant was entitled to impose upon the respondent its own view on what should be the correct price.²³⁵³

The decision maker applying *lex mercatoria* should not consider that a mere change of circumstances implies a duty to renegotiate the contract, which is silent in that respect, solely on the basis of such ideas that long-term contractual relationships require closer cooperation between the parties. In order for a duty of renegotiation between the parties to arise from the basic principle of good faith and fair dealing under *lex mercatoria*, there must be a gap in the risk allocation agreed by the parties with regard to the change of circumstances, which cannot be resolved by means of interpretation or adjustments in the determination of the risk assessments. It should be noted that due to such features of the doctrine of hardship under *lex mercatoria*, the adjustments in the determination of risk assessments will usually resolve the dispute by determining the consequences of the change of circumstances with regard to the contractual obligations of the parties and, thus, negate the need to proceed with the default mechanisms, as it can be observed in the Questech award. Given that the central issue with regard to hardship under *lex mercatoria* is the risk allocation, only if there are no explicit or implicit indications as to the risk allocation agreed between the parties and the parties fail to agree on a solution through renegotiation, these risks must be allocated by the decision maker in such a way that upholds the underlying bargain and the reasonable expectations of the parties to a particular contract.

It is argued that under general contract principles and in the absence of a renegotiation clause, an infringement of the duty to renegotiate by the party which is confronted with a request for renegotiation should generally not result in liability for damages, and only when a party enters into negotiations and negotiates or breaks off negotiations in bad faith, it may become liable for the losses caused to the other party, which will be limited to the expenses incurred by the aggrieved party in the negotiations. In this view, since there is an intrinsic link between the renegotiation phase and the subsequent judicial proceedings, an infringement of the duty to renegotiate should exclusively entail the consequences in the context of the cost allocation of the subsequent court or arbitral proceedings.²³⁵⁴ However, the renegotiation is an important element of the concept of hardship under *lex mercatoria*, which is based on a notion of risk allocation, and it is the key differentiating factor between hardship and force majeure. The abstractions from the national legal systems reveal that it is a concern in the different approaches to the question of hardship to encourage the parties to resolve themselves through cooperation the problems arising from hardship situations.

Essentially, the parties to international contracts usually enter into negotiations on their own motion in the presence of unforeseen contingencies that affect the equilibrium of the bargain. Thus, the decision maker should maintain and encourage such established practices in the order of international commerce. As *lex mercatoria* does not provide an *ex ante* or pre-established model for the hardship situations in the form of a simple solution, such as the preservation, termination or adaptation of the original contract, which can be found in a particular legal system, it would not be possible to encourage the parties to renegotiate

²³⁵³ ICC Final Award in Case No 9994, December 2001, ICC International Court of Arbitration Bulletin, Special Supplement 2005: UNIDROIT Principles: New Developments and Applications, (2005), at 79

²³⁵⁴ Brunner, Christoph, Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration, Kluwer Law International, 2009, at 481-482

without the ex post decision maker motivating them to consider it as a duty, the violation of which entails some financial consequences. Thus, if a party violates this duty in bad faith, whereby the process is unjustifiably delayed or intentionally obstructed or the proposals by the other party are obviously rejected for reasons other than normal business judgment, the other party should at least be entitled to claim compensation for its losses arising from delay and costs incurred in reliance on reaching a solution. In the end, the process of renegotiation and the parties' subsequent conduct may provide direct indications for the decision maker devising a solution in accordance with the reasonable expectations of the parties. For instance, in ICC Case No. 7365, the evidence of negotiations and the parties' subsequent conduct indicated that the parties agreed on the termination of the contracts and the tribunal did not have to adapt the contract terms on the basis of its discretion, even if it was apparently prepared to do so. However, since the parties under the duty to negotiate are not obligated to agree, the decision maker applying *lex mercatoria* should not impose the proposal of one party on the other party by adapting the contract or awarding positive interest as damages on the basis of that proposal, unless he is authorized by the terms of the contract or applicable default rules to impose a reasonable solution, or he finds a correspondence of expectations of the parties with regard to such a proposal from the evidence of negotiations.

3. Concluding Remarks

In cases of hardship, there is a gap of contractual risk allocation in relation to the change of circumstances, which render performance excessively onerous, thereby resulting in costs, which have been neither contemplated nor allocated by the parties through the articulated rules. In the first instance, the hardship situations under *lex mercatoria* should lead the decision maker to consider the renegotiation of the agreement by the parties with a view to adapting the contract or terminating it thereby enabling them to arrive at the allocation had they contemplated and allocated the relevant risks at the time of contracting. If the parties fail to agree on a solution through renegotiation, these risks must be allocated by the decision maker in such a way that upholds the underlying bargain and the reasonable expectations of the parties to a particular contract. In such cases, the decision maker should refer to the mechanisms provided by the default rules chosen by the parties or applicable pursuant to the established rules of conflict, while taking into account the evidence of renegotiations and other subsequent conduct if available. The issue of idiosyncrasy in the applicable national rules will not arise in this respect due to the divergence of approaches in the default mechanisms of the relevant doctrines of change of circumstances. The default mechanisms will eventually require the decision maker to adopt one of the three solutions: the termination, preservation or adaptation of the original contract.²³⁵⁵

In cases where *lex mercatoria* governs the substance of the dispute to the exclusion of any national law, the solution of adaptation should be covered by either party's petitions or evidence, so that the issue comes under the scope of the parties' delegation to the decision maker of controlling legal uncertainty. Thus, in such cases, the decision maker should not

²³⁵⁵ For instance, in ICC Case No. 2708, the dispute concerned the respondent's request for an increase in the contract price due to the change in the market price of the goods. The tribunal rejected the defense based on change of circumstances, since there was no such defense to be found in the applicable French law. The tribunal also noted that many commercial contracts were concluded in the hope that subsequent changes in market prices would render the contract profitable. The tribunal held that while parties were free to include an express term providing for adaptations to changing conditions, the lack of such an express clause in the present contract meant that the contractual obligations could not be set aside. ICC Award in Case No. 2708, *Journal du Droit International* (1977), at 943 et seq.

adapt the contract to the change of circumstances, if neither party requests for adaptation, since the ex officio adaptation of the contract by the decision maker requires an authorization from the articulated or established rules in the particular case, but there is no established rule in the order of international commerce that grants such an authority to the decision maker unconditionally. If a party requests the adaptation of the contract, the decision maker should require such party to reasonably substantiate the contents of its request, and the decision maker should satisfy the basic principles of equal treatment of parties and due process under *lex mercatoria*. If the decision maker is not given sufficient indications as to how the alternative terms should be determined, he may have to dismiss the claim for adaptation, and turn to determining the conditions of termination and its possible consequences.

In adapting the contract to the changes circumstances, the decision maker should take into account the bargain underlying the original contract. Thus, the adaptation of contract in case of an increased cost of performance or decreased of value of counter-performance should be made in light of the widespread understanding across the sources of abstraction that a party is bound to fulfill its obligation even if performance has become more onerous. The decision maker should consider that the aggrieved party bears the risk that the cost of performance may increase or that the value of the performance it receives may diminish, and adjust the contract to the extent necessary for removing the “excessive onerousness” in the performance and rendering the cost or value of the performance within the scope of risk that has been undertaken by the aggrieved party.²³⁵⁶ In the cases of termination of the contract due to hardship, the decision maker should take into account the relevant considerations with regard to the general right to terminate the contract, and consider that the recoverable damages, as a supplementary remedy, may also include losses incurred by a party arising from delay and costs on reaching an agreement during the renegotiation of the original agreement if the other party rejected to negotiate, or negotiated or broke off negotiations in bad faith.

However, the decision maker applying *lex mercatoria* should never engage in an exercise of adaptation of the contract due to hardship in the absence of sufficient indications in the evidence of negotiations or the parties’ pleadings as to the alternative terms, when *lex mercatoria* governs the substance of the dispute exclusively, or without having regard to the specific requirements of judicial adaptation, when the articulated or established rules in the particular case address the issue of hardship, since such an exercise of adaptation can be considered as an instance of equity contra legem and of splitting the difference, which may never serve the aim of accuracy in reflecting the reasonable expectations of the parties.

²³⁵⁶ See for the same view: Illustration 4 in the Comment on Article 6:111 of the PECL: “A town council has arranged for the supply of electricity by a private company at a fixed tariff. If the price of the coal used to produce the electricity increases dramatically because of shortages, the additional payment which the town should be required to make should not cover the whole of the additional cost of the coal. Part of the extra cost should fall on the company.” Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 325

v. Right to terminate the contract

The basic principle of *pacta sunt servanda* under *lex mercatoria* provides that the contract can only be terminated by the explicit or implicit agreement of the parties, in accordance with the articulated rules, which include the contract terms and the default rules chosen by the parties, or on the basis of the qualifying function of the basic principle of good faith and fair dealing. When there are residual issues arising from the articulated rules, due to the incorporation of a vague standard or failure to deal with a particular contingency regarding the termination of a particular contract, the decision maker applying *lex mercatoria* will have to interpret or supplement those rules in order to determine the conditions, procedures and consequences of the termination of the contract, on the basis of an accurate reflection of their reasonable expectations. The main issues with the right to terminate the contract under *lex mercatoria* are to determine and define the threshold of seriousness of circumstances, which allow a party to abandon the bond of *pacta sunt servanda*, the process for the exercise of the right to terminate, and the effect of termination on the contractual relationship.

1. Sources of Abstractions

a. National Laws

The right to terminate the contract under national legal systems mainly exists, when there is an actual or imminent non-performance of the contract, which is not excused and attains a certain degree of seriousness. Some legal systems also allow for the possibility of termination of the contract for a just cause, namely extraordinary change of circumstances resulting from objective events, which substantially affect a party's ability to continue to perform under an unchanged contract. In many legal systems, the court has some discretion in assessing whether the contract is to be terminated, due to the uncertain nature of vague standards employed in determining the required degree of seriousness of non-performance or other causes that justify the termination of the contract.²³⁵⁷

The general principle of French law with regard to the termination of the contract is stated in Article 1184 of the Civil Code. Article 1184 (1) provides all bilateral contracts with an implied term, in the form of a resolutive condition, for the event a party fails to perform his undertaking. Article 1184 (2) provides that in a case, where one of the parties does not perform its obligations, the contract is not "resolved" automatically by the operation of law. The aggrieved party may claim either performance, or resolution (termination) and damages, but he must seek termination in legal proceedings before a court. Moreover, the aggrieved party must give the other party a "*mise en demeure*", whereby the non-performing party is put in default through a notification of the delinquency, in order to claim termination.²³⁵⁸

²³⁵⁷ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 578

²³⁵⁸ Mercadal, Barthélémy, *Termination of Contracts under French Law*, *International Business Law Journal*, (1997), at 875 Although required as a preliminary to the remedy of termination, it is usually unimportant for remedies other than damages, since the action for remedies constitute a *mise en demeure* and there is no advantage in establishing an earlier date with respect to the remedies other than damages. Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 238

Article 1184 merely prescribes how termination must be sought without specifying any legal criterion which would justify termination on the ground of non-performance.²³⁵⁹ When the aggrieved party applies to the court for an order resolving the contract, the court exercises its discretion in order to decide whether the claim for termination is justified. Where there is a total non-performance, the court will usually order termination, but it may also grant the non-performing party a period of grace, under Article 1184 (3), to allow him to perform his obligation, if the court considers that the aggrieved party is seeking to take advantage of a temporary difficulty in order to escape from a bad bargain.²³⁶⁰ In the cases of defective or partial performance, the court will exercise its discretion by having regard to various factors, such as the defendant's degree of fault and the gravity of non-performance.²³⁶¹ In those cases, the court will assess whether the non-performance is sufficiently serious to justify termination, or whether the non-performing party's conduct is in bad faith and justifies termination, even if the non-performance is not sufficiently serious. On the basis of these assessments, the court will decide whether the contract should be terminated in full or, instead, the debtor should be given a grace period. The court may also order an intermediate solution, for example, of partial resolution of the contract with a reduction in price.²³⁶²

Article 1134 of the French Civil Code, which was based on the principle of *pacta sunt servanda*, has been traditionally seen as the basis of all remedies for breach of contract, whether they are provided for by legislation, case law or the agreement itself.²³⁶³ As the starting point is the fundamental principle of Article 1134 that agreements legally formed have the force of law for the parties, it is considered as the right of the creditor to require the debtor to render the actual performance of the obligation. This approach to the rule under Article 1134 in the meaning that the contract must be performed leads to the opposition to the termination of the contract under French law. Under such an approach, the contract must be upheld, even in cases of non-performance.²³⁶⁴ Thus, at any time before the court has ordered termination, the non-performing party can prevent termination by offering to perform. On the other hand, the aggrieved party is not barred from claiming performance merely because he has claimed termination. This reflects the approach of French law, which regards termination, as an extraordinary remedy, while performance or damages being generally preferred.²³⁶⁵

Under French law, there are a number of exceptions to the rule that termination requires an order of the court. First, the parties may agree on an express provision for termination. As Article 1184 is not considered as a mandatory rule, the parties are generally free to provide that in certain events the contract will be terminated by the operation of law.²³⁶⁶ However, the

²³⁵⁹ Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 112

²³⁶⁰ Nicholas, Barry, The French law of contract, Oxford University Press, 1992, at 242

²³⁶¹ Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 112

²³⁶² Bell, John, Sophie Boyron & Simon Whittaker, Principles of French law, Oxford University Press, 2nd ed., 2008, at 357

²³⁶³ Laithier, Yves-Marie, Comparative Reflections on the French Law of Remedies for Breach of Contract, in Nili Cohen & Ewan McKendrick, Comparative Remedies for Breach Of Contract, Oxford: Hart, 2005, at 105

²³⁶⁴ *Ibid.*, at 116

²³⁶⁵ Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 113

²³⁶⁶ Bell, John, Sophie Boyron & Simon Whittaker, Principles of French law, Oxford University Press, 2nd ed., 2008, at 357, at 358

French courts tend to construe contractual termination clauses strictly against the parties seeking to take advantage of them. Moreover, even a clause, which is explicit to exclude the need for recourse to the court, does not relieve the aggrieved party from giving a *mise en demeure*, which has not been excluded by agreement explicitly or implicitly, so as to exercise its contractual right to terminate.²³⁶⁷ A properly drafted termination clause, on the other hand, may enable the parties to terminate the contract for some relatively minor default, but subject to the requirements of the principle of good faith.²³⁶⁸ In those cases, the court may only intervene if a dispute arises, but its power is limited to taking notice of termination, which has to be determined according to the terms of the contract.²³⁶⁹

The second exception to the requirement of a court order for termination arises from the French case law, according to which the creditor may immediately terminate the contract when the conduct of the debtor has become so bad that the continuation of the contractual relationship has become impossible or unbearable. The early case law related to the dismissal of employees, but the rule has been extended to other cases where there is a special relationship of trust and confidence between the parties, where there is an urgent need to protect the creditor's interest, and where the breach is so destructive of trust as to make continuance of the contractual relationship intolerable.²³⁷⁰ A *mise en demeure* is not required in those cases if it would serve no purpose.²³⁷¹ This approach to termination aims at overcoming the laborious mechanism of termination, and it is justified only if immediately declared. In those cases, the aggrieved party may terminate the agreement without a sufficient notice period, but at its own risk and peril.²³⁷² The matter is ultimately subject to judicial control, as it remains open to the debtor to go to court and ask it to refuse to recognize the creditor's act of termination, and the exact conditions justifying this form of unilateral termination are not clear.²³⁷³

As termination is in principle a judicial remedy under French law, available at the discretion of the court, one of the principal factors, which the court takes into account in exercising that discretion, is the degree of the fault. Particularly, a creditor may treat a contract as discharged without getting a prior judgment for termination in cases of declared refusal by the debtor to perform.²³⁷⁴ This exception to the general requirement of applying to court for termination may also be relevant to the case of a declaration made before the date for performance. Thus, it resembles the approach under common law systems, where anticipatory breach may allow

²³⁶⁷ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 244

²³⁶⁸ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 113

²³⁶⁹ Laithier, Yves-Marie, *Comparative Reflections on the French Law of Remedies for Breach of Contract*, in Nili Cohen & Ewan McKendrick, *Comparative Remedies for Breach Of Contract*, Oxford: Hart, 2005, at 118

²³⁷⁰ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 245

²³⁷¹ *Ibid.*, at 239

²³⁷² Laithier, Yves-Marie, *Comparative Reflections on the French Law of Remedies for Breach of Contract*, in Nili Cohen & Ewan McKendrick, *Comparative Remedies for Breach Of Contract*, Oxford: Hart, 2005, at 119

²³⁷³ Whittaker, Simon, 'Termination' for Contractual Non-performance and its Consequences: French Law Reviewed in the Light of the *Avant-projet de réforme*, in J. Cartwright, S. Vogenauer, & S. Whittaker (eds), *Reforming the French Law of Obligations: Comparative Reflections on the Avant-projet de réforme du droit des obligations et de la prescription ('the Avant-projet Catala')*, Hart, 2009, at 192-193

²³⁷⁴ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 139-140

the termination before the time at which performance was actually due. However, in such cases under French law, a creditor may treat the contract as though it is at an end, after the date for performance arrives, at the risk of a court subsequently holding that he was not entitled to terminate, but his action will not be treated as wrongful merely because he acted without first getting a judgment.²³⁷⁵

Under French law, the general principle is that termination can operate not only prospectively, discharging the parties from their obligations of future performance, but also retrospectively, thereby placing the parties back into the situation in which they would have been had the contract never been concluded, and imposing on the parties the duty to return what they have already received on the basis of the contractual agreement.²³⁷⁶ Article 1183 of the French Civil Code provides for the retrospective dissolution of the contract as the main result of the termination.²³⁷⁷ French law recognizes that the retrospective effect of termination does not wipe out all contractual terms. Particularly, such contract terms as exemption clauses, penalty clauses and termination clauses survive, since they regulate the consequences of non-performance.²³⁷⁸ Moreover, the courts accept that sometimes a creditor's request for the termination of contract takes effect only prospectively. In such situations, where this is recognized by the Civil Code, the creditor is said to effect the "résiliation" of the contract.²³⁷⁹ In cases of "résiliation", there is no general dissolution of the contract with its related obligations of restitution and counter-restitution by the parties. The parties may keep the benefit of what each has done for the other under the contract until the time of non-performance, while they are released from their obligations for the future. According to the French legal doctrine, *résiliation*, whether judicial or unilateral, can take place where performance of the contract is continuous or in installments on the grounds that restitution and counter-restitution presents too many difficulties in such cases. It is also argued that the proper justification of the prospective effect of *résiliation* is the protection of reliance rather than any ostensible difficulty in restitution or counter-restitution, given the possibility of restitution of an equivalent value (*restitution en valeur*).²³⁸⁰

In French law, it is assumed that liability for contractual non-performance remains contractual even if the contract is 'destroyed' by termination.²³⁸¹ Thus, even if terminated, the contract can still provide a proper basis for a claim for damages. Article 1184 of the French Civil Code explicitly provides that resolution may be combined with damages. The damages are assessed

²³⁷⁵ Whittaker, Simon, *How Does French Law Deal with Anticipatory Breaches of Contract?*, *International and Comparative Law Quarterly*, 45-3 (Jul., 1996), at 665

²³⁷⁶ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 141

²³⁷⁷ The retrospective dissolution has not only a "personal" but also a "proprietary" effect, which favors restitution in kind also in situations where the rights conferred under the terminated contract had been transferred to a third party so that termination is capable of affecting the rights of third parties. Torsello, Marco, *Remedies for Breach of Contract*, in Jan Smits (ed.), *Elgar Encyclopedia of Comparative Law*, Edgar Elgar Publisher, Aldershot, 2006, at 615

²³⁷⁸ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 245

²³⁷⁹ Articles 1636, 1638, and 1729 of the French Civil Code

²³⁸⁰ Whittaker, Simon, 'Termination' for Contractual Non-performance and its Consequences: French Law Reviewed in the Light of the *Avant-projet de réforme*, in J. Cartwright, S. Vogenauer, & S. Whittaker (eds), *Reforming the French Law of Obligations: Comparative Reflections on the Avant-projet de réforme du droit des obligations et de la prescription ('the Avant-projet Catala')*, Hart, 2009, at 194

²³⁸¹ *Ibid.*, at 200

on a normal basis, such as where damages are claimed in case of non-performance. Thus, the French approach does not start with the assumption that termination and damages are logically inconsistent, and it avoids needless complexities and the risk of serious injustice in denying the most appropriate remedies.²³⁸²

German law does not require an order by a court for the termination of the contract. Termination is effected by a declaration made by the aggrieved party pursuant to Section 349 of the German Civil Code. Under German law, the notice of termination does not have to be in any particular form, but it must require the debtor to perform its obligations and specify a reasonable time within which it is required to do so. If the specified time is too short, the notice does not become invalid. A reasonable time will begin to run where the creditor has deliberately set a time which is so short that it indicates lack of good faith.²³⁸³ However, there is no need to serve a notice on the non-performing party in order to put the latter into breach and to enable the right to terminate (*Mahnung*, *mise en demeure*).²³⁸⁴

German law emphasizes the right to performance, and grants the debtor a right to a second chance to perform in many instances.²³⁸⁵ In order to preserve the balance of interests in the termination of the contract, the German model is based on a general requirement that the aggrieved party first has to set an additional period of time to allow the non-performing party a second chance, except for the cases of an obviously fundamental or incurable breach. Thus, the mere failure of the obligor to perform does not entitle the obligee to terminate the contract. As long as performance remains possible, the obligor must first give the obligee a notice requiring him to perform within a stated additional period of time ("*Nachfrist*"), pursuant to Section 323 of the German Civil Code.²³⁸⁶ Section 323 dispenses with the *Nachfrist* requirement if the obligor refuses to perform, if time was of the essence, or in other "special circumstances", which, having due regard to the parties' interests, justify immediate termination. The proposal of the first Law Reform Commission had favored another model, which grants the right to terminate the contract to the obligor in cases of fundamental breach, while providing the instrument of a request which makes time of the essence by setting a period of grace for cases where the seriousness of breach might be uncertain.²³⁸⁷ This model has a limited effect on Section 324 of the German Civil Code after the reform in 2002, which allows termination in cases of breach of protective duties of care, but the term "fundamental breach" is replaced by the requirement that the obligor "can no longer reasonably be expected to abide by the contract" Moreover, in order to ensure that minor breaches may not be used as an excuse for terminating the contract through *Nachfrist* mechanism, Section 323 (5) of the German Civil Code provides that if the performance has been defective, termination depends

²³⁸² Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 147

²³⁸³ Ibid., at 115

²³⁸⁴ Before the reform, where no exact time for performance had been agreed upon by the parties, a notice (*Mahnung*) was necessary for the right to terminate due to delayed performance. Coester-Waltjen, Dagmar, The New Approach to Breach of Contract in German Law, in Nili Cohen & Ewan McKendrick (eds.), Comparative Remedies For Breach of Contract, Oxford: Hart, 2005, at 142

²³⁸⁵ Ibid., at 138

²³⁸⁶ Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 115

²³⁸⁷ Schlechtriem, Peter, The German Act to Modernize the Law of Obligations in the Context of Common Principles and Structures of the Law of Obligations in Europe, Oxford U Comparative L Forum, 2 (2002), at ouclf.iuscomp.org, text after note 37

on the weight of the defect, and minor defects do not give rise to the right of termination. It is also provided that in cases where the debtor has performed in part, the creditor may terminate the complete contract only if only if he has no interest in partial performance.²³⁸⁸

Originally, the drafters of the German Civil Code of 1900 regarded fault, a prerequisite for a damage claim, as indispensable for the aggrieved party's right to terminate the contract.²³⁸⁹ However, the notion of "fault" in the context of termination was a wider one than the corresponding notion in relation to liability for damages. The phrase used to describe the requirement of "fault" in the context of termination was "for which he is responsible".²³⁹⁰ After the reform in 2002, the requirements for the right to terminate still largely mirror the conditions for a claim for damages in lieu of performance. This assimilation reflects a desire, on the part of the drafters of the reform, to prevent any danger of the requirements for termination of contract effectively being subverted by the possibility of resorting to the remedy of damages in lieu of performance.²³⁹¹ However, there is one major difference between the requirements for termination and for a claim for damages in lieu of performance, and, thus, between the old and the new law. The availability of the remedy of termination does no longer depend on whether or not the debtor has been at fault.²³⁹² The right to terminate is not limited to non-excused impediments of performance. Pursuant to Section 323 (6), the only further requirement for termination is that the creditor should not be solely or overwhelmingly responsible for the debtor's breach, or the creditor, even if not responsible, should not be at default in accepting performance before the debtor's breach.²³⁹³

Under German law, where the debtor has seriously and definitively refused to perform, the creditor does not have to fix an additional period for performance in order to terminate the contract pursuant to Section 323(2)(1) of the German Civil Code. Section 323 (4) provides that this applies even if such refusal has occurred before the time for performance has arrived. However, it should be noted that generally in civil law systems the anticipatory non-performance solely affects the requirements of termination, e.g. putting the non-performing party at default, fixing an additional period of performance or applying to the court for termination. Unlike common law systems, they do not entitle the aggrieved party to terminate the contract before performance has become due.²³⁹⁴

In the case of contracts to be performed over a period of time, the German Civil Code, after the reform, contains a special provision granting the aggrieved party a right to terminate the

²³⁸⁸ Coester-Waltjen, Dagmar, *The New Approach to Breach of Contract in German Law*, in Nili Cohen & Ewan McKendrick (eds.), *Comparative Remedies For Breach of Contract*, Oxford: Hart, 2005, at 141

²³⁸⁹ Schlechtriem, Peter, *Termination of Contracts under the Principles of International Commercial Contracts*, in Michael Joachim Bonell & Franco Bonelli (eds.), *Contratti commerciali internazionali e Principi UNIDROIT*, Giuffr , Milano 1997, at 254

²³⁹⁰ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, T bingen: Mohr, 1976, at 122-123

²³⁹¹ Zimmermann, Reinhard, *Breach of Contract and Remedies Under the New German Law of Obligations*, *Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari* 48, Rome, 2002, at 37-38

²³⁹² *Ibid.*, at 39

²³⁹³ Coester-Waltjen, Dagmar, *The New Approach to Breach of Contract in German Law*, in Nili Cohen & Ewan McKendrick (eds.), *Comparative Remedies For Breach of Contract*, Oxford: Hart, 2005, at 142

²³⁹⁴ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, T bingen: Mohr, 1976, at 140

contract for a good cause. Pursuant to Section 314 of the German Civil Code, either party may terminate a contract for the performance of a recurring obligation on notice with immediate effect if there is good cause for doing so. The existence of a good cause is determined on the basis of whether the terminating party cannot reasonably be expected to continue the contractual relationship until the agreed termination date or until the end of a notice period by having regard to all the circumstances of the specific case and balancing the interests of both parties. German law does not limit the right to terminate for a good cause to cases involving a breach of contract. In particular, in case of long-term contracts, which require a close cooperation of the parties on the basis of mutual trust, the breakdown of the parties' relations may justify the termination of the contract for a good cause.²³⁹⁵ This type of termination is called "*Kündigung*" and merely operates prospectively.²³⁹⁶

For the cases other than that of *Kündigung*, Section 346 of the German Civil Code provides that at termination, both parties have the right to recover money paid, property supplied and other means of performance or counter-performance.²³⁹⁷ This is the resolution of the contract ("*Rücktritt*"), which operates retrospectively and implies the liquidation of the parties' reciprocal rights and duties.²³⁹⁸ Thus, in German law, after termination, both parties have a duty to return to each other what they have received under the contract. Whenever possible, restitution should be made in kind.²³⁹⁹ If restitution in kind is not possible, an allowance is to be made in money for the value received. After the reform, restitution is not to be rendered in terms of the law of unjustified enrichment. The German Civil Code, rather, makes available a specific restitution regime for this purpose through Section 346. This regime deals with the position of the party terminating the contract as well as with that of the other party. In the doctrine, the existence of this specific restitution regime has always been justified by pointing out that termination does not remove the entire contract and does not, therefore, create a situation where the performance can be said to have been made without legal ground. The specific restitution regime transforms the contractual relationship originally agreed upon into a contractual winding-up relationship.²⁴⁰⁰ As termination of the contract merely transforms the contractual relationship, it does not affect contractual provisions, such as dispute settlement clauses.²⁴⁰¹

Under German law, before the reform, termination of contract and the claim for damages were incompatible. There was a sharp distinction between two senses of termination: refusal to accept performance and *Rücktritt*. While refusal to accept performance was not regarded as termination and, thus, it could be combined with a claim for damages, *Rücktritt* deprived the

²³⁹⁵ Brunner, Christoph, Force majeure and Hardship under General Contract Principles: Exemption for Non-Performance in International Arbitration, Kluwer Law International, 2009, at 519

²³⁹⁶ Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 126

²³⁹⁷ Coester-Waltjen, Dagmar, The New Approach to Breach of Contract in German Law, in Nili Cohen & Ewan McKendrick (eds.), Comparative Remedies For Breach of Contract, Oxford: Hart, 2005, at 143

²³⁹⁸ Kraft, Walter, Termination of Contracts under German Law, International Business Law Journal, (1997), at 893

²³⁹⁹ German law creates only a personal duty of restitution and has no proprietary effects. Torsello, Marco, Remedies for Breach of Contract, in Jan Smits (ed.), Elgar Encyclopedia of Comparative Law, Edgar Elgar Publisher, Aldershot, 2006, at 615

²⁴⁰⁰ Zimmermann, Reinhard, Breach of Contract and Remedies Under the New German Law of Obligations, Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari 48, Rome, 2002, at 39

²⁴⁰¹ Ibid., at 42-43

aggrieved party of his right to damages for non-performance. Where a contract was terminated in the sense that one party duly declared Rücktritt, the Civil Code made termination alternative to damages for non-performance, so that the two remedies could not be combined.²⁴⁰² After the reform, termination no longer precludes a claim for damages based on the contract. This is now specifically stated in Section 325 of the German Civil Code. In principle, termination of the contract and all kinds of damages are compatible.²⁴⁰³

The general principle in common law is that termination of a contract for non-performance can be achieved simply through a notice of termination given by the aggrieved to the non-performing party. The notice does not have to be in any particular form. A process of termination by an order of the court is not normally required. However, it is possible for the aggrieved party to obtain a judgment to the effect that the contract is or has been terminated, when it may be desirable for clarifying the legal position. Moreover, a judgment must often be obtained to give effect to the consequences of termination, in the sense of restitution.²⁴⁰⁴ In common law, a breach will justify termination if it frustrates the aggrieved party's purpose in entering the contract or if it "substantially" deprives him of what he bargained for.²⁴⁰⁵ In other words, the termination of a contract for non-performance can be justified if the non-performance is of an "essential" term.²⁴⁰⁶ A prior formal notice in the nature of a Nachfrist is not normally required. If a stipulation as to time is an essential term, failure by one party to perform it within the stated time generally gives the other party the right to terminate the contract. Where time is not of the essence of the contract, the aggrieved party can in effect make it of the essence by giving notice to the other party calling upon him to perform within a specified reasonable period.²⁴⁰⁷

In England, the question whether or not a promise is "essential" is discussed within the context of a classification of contractual terms, as "conditions", "warranties" and "innominate terms". A condition is an essential term of the contract which goes to the root or the heart of the contract.²⁴⁰⁸ When it is breached, the aggrieved party may either terminate the contract and obtain damages for any loss suffered as a result of the breach, or affirm the contract and recover damages for the breach. A warranty on the other hand is a lesser or subsidiary term of

²⁴⁰² Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 146

²⁴⁰³ Coester-Waltjen, Dagmar, The New Approach to Breach of Contract in German Law, in Nili Cohen & Ewan McKendrick (eds.), Comparative Remedies For Breach of Contract, Oxford: Hart, 2005, at 154

²⁴⁰⁴ Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 119

²⁴⁰⁵ Ibid., at 129

²⁴⁰⁶ Zweigert, Konrad & Hein Kötz, An Introduction to Comparative Law, translated by Tony Weir, Oxford University Press, 3rd rev. ed., 1998, at 505

²⁴⁰⁷ Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 120

²⁴⁰⁸ The use of the word "condition" in this context differs from the meaning of a condition in the sense of an event upon which the contract hinges. A condition in the latter meaning is commonly called as a contingent condition. A contingent condition may be either a condition precedent or a condition subsequent. A condition precedent provides that the contract shall not become binding until the occurrence of a specified event. A condition subsequent provides that a previously binding contract shall come to an end on the occurrence of a specified event. The word "condition" in the context of the termination of the contract denotes an essential term of a contract, non-performance of which gives the aggrieved party the right to terminate the contract. Zweigert, Konrad & Hein Kötz, An Introduction to Comparative Law, translated by Tony Weir, Oxford University Press, 3rd rev. ed., 1998, at 505

the contract. A breach of a warranty only enables the aggrieved party to claim damages, but he cannot terminate the contract and must, therefore, continue to perform his obligations under the contract.²⁴⁰⁹ In order to provide a greater degree of remedial flexibility, a third category has been recognized in English law. In *Hong Kong Fir Shipping Co. Ltd. v. Kawasaki Kisen Kaisha Ltd.*, Diplock LJ stated that there exist “many contractual undertakings of a more complex nature which cannot be categorized as being “conditions” or “warranties”.”²⁴¹⁰ Diplock LJ’s reference to “complex undertakings” led to a third category of terms and the terminology in subsequent decisions reflected this by referring to “innominate terms” and “intermediate stipulations.”²⁴¹¹ A breach of an innominate term enables the aggrieved party to terminate the contract only where the breach has had serious consequences for him. In deciding whether or not the breach was of a sufficiently serious character, the courts will have regard to all the relevant circumstances of the case.²⁴¹²

Under English law, there is a considerable difficulty of distinguishing among a condition, a warranty and an innominate term. A term will generally be regarded as a condition if it has previously been recognized as such by statute or precedent, or if it appears that it was the intention of the parties that a particular term is to be a condition. However, the court will not treat a term as a condition if the result of such a construction would be unreasonable.²⁴¹³ It is observed, in practice, that the courts have been reluctant to find that a term is a condition unless there is clear evidence to justify such a conclusion.²⁴¹⁴ In *Bunge Corp v. Tradax Export S. A.*, Wilberforce L.J. said that “It remains true... that the courts should not be too ready to interpret contractual clauses as conditions.”²⁴¹⁵ The classification of a term as a warranty is also rare as the emergence of the new category of innominate terms appears to have reduced the number of occasions when a term will be classified as a warranty.²⁴¹⁶ The contracting parties are free to classify terms as warranties or conditions. However, if they wish to confine a term to the status of warranty, they should “make it plain from the contract as a whole” that the term is only a warranty.²⁴¹⁷

The legal classification of contractual terms is based on the assumption that the effect of non-performance of some obligations is more serious than the effect of non-performance of others.²⁴¹⁸ As the bipartite classification of conditions and warranties inevitably introduces an

²⁴⁰⁹ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 211

²⁴¹⁰ [1962] 2 Q.B. 26, at 70

²⁴¹¹ The House of Lords, in *Bunge Corporation, New York v. Tradax Export S.A.*, Panama [1981] 1 W.L.R. 711, gave its decision in favor of this tripartite classification.

²⁴¹² McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 219-220

²⁴¹³ See e.g., the statement of Lord Denning M.R in *Wickman Machine Tool Sales Ltd. v. Schuler A. G* [1972] 1 W.L.R. 840 at 851. The view was also confirmed by Lord Reid at the House of Lord. *L Schuler AG v Wickman Machine Tools Ltd* [1974] A.C. 235 at 251.

²⁴¹⁴ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 221

²⁴¹⁵ [1981] 1 W.L.R. 711 at 715

²⁴¹⁶ Carter, J.W., *Classification of Contractual Terms: the New Orthodoxy?*, *Cambridge Law Journal*, 40 (1981), at 221

²⁴¹⁷ *Olympia & York Canary Wharf Ltd (No.2)*, [1993] B.C.C. 159, at 166

²⁴¹⁸ A similar legal classification can be found in German law, between failure to perform a principal duty and a subsidiary duty. Before the reform, only a failure to perform a duty of the former kind gave rise to a right to terminate the contract. However, the distinction between principal and subsidiary duties in German law is less rigid than the English distinction between conditions and warranties. Even before the reform in German law, the

element of rigidity and tend to distract attention from the effects of non-performance in individual cases, an element of flexibility is introduced through the concept of “innominate term” which requires the court to engage in a balancing exercise. Thus, the court is required to evaluate the competing policy considerations of certainty and justice and to assess their weight on the facts and circumstances of the individual case.²⁴¹⁹ The English courts engage in such a balancing exercise, and both policies of fairness and certainty have been supported by various judicial decisions.²⁴²⁰

In the United States, the Restatement (Second) of Contracts dispenses with the distinction between conditions and warranties on the question of termination.²⁴²¹ While the mere presence of a breach does not entitle the aggrieved party to terminate the contract, it is generally stated that a “material failure” to perform by a party may entitle the aggrieved party to terminate the contract.²⁴²² The reference to “material failure” instead of “material breach” in US law is important in that the former is a broader concept, including any non-performance, defective performance, or late performance. If the failure was not justified, for example by impracticability, the failure amounts to a breach of contract. A non-justified material failure is the Restatement terminology used to refer to a material breach.²⁴²³ In determining whether a failure of performance is material, the circumstances listed in Section 241 can be considered. These include (1) the extent of the deprivation of a reasonably expected benefit to the aggrieved party; (2) the extent of the deprivation of adequate compensation for part of the benefit the aggrieved party will be deprived; (3) the extent of forfeiture suffered by the party failing to perform; (4) the likelihood the party failing to perform will cure his or her failure; and (5) the extent to which the party failing to perform does or does not comport with the requirement of good faith and fair dealing. If the failure to perform is immaterial, the aggrieved party may not terminate the contract, but he may claim damages for breach.

The Restatement explains that material failure of performance, which includes defective performance as well as an absence of performance, operates as the nonoccurrence of a

classification of a duty as principal or subsidiary was more flexible, depending on the importance to be attached to the performance of the duty in the light of the particular contractual context. Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 134-135. After the reform, Section 324 of the German Civil Code explicitly allows the aggrieved party to terminate the contract for the non-performance of a subsidiary duty if he can no longer reasonably be expected to abide by the contract.

²⁴¹⁹ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 221

²⁴²⁰ The policy of fairness favoring the classification of terms as innominate was illustrated by *Hong Kong Fir Shipping Co. Ltd. v. Kawasaki Kisen Kaisha Ltd.*, [1962] 2 Q.B. 26; *Cehave N.V. v. Bremer Handelsgesellschaft mbH (The Hansa Nord)* [1976] 1 Q.B. 44; *Tradax Internacional S.A. v. Goldschmidt S.A.* [1977] 2 Lloyd's Rep. 604; whereas, the policy emphasizing the requirement of commercial certainty and predictability favoring the classification of terms as conditions was illustrated by *Bunge Corp v. Tradax Export S. A.* [1981] 1 W.L.R. 711; *Gill & Duffus S.A. v. Societe Pour L' Exportation des Sucres S.A.* [1986] 1 Lloyd's Rep. 322.

²⁴²¹ Zweigert, Konrad & Hein Koetz, *An Introduction to Comparative Law*, translated by Tony Weir, Oxford University Press, 3rd rev. ed., 1998, at 506

²⁴²² Restatement (Second) of Contracts, Chapter 10, Topic 2

²⁴²³ Van Vuuren, Elbi Janse, Termination of International Commercial Contracts for Breach of Contract: The Provisions of [South African Contract Law, U.S. Contract Law, German Contract Law and] the UNIDROIT Principles of International Commercial Contracts, *Arizona Journal of International & Comparative Law*, 15 (1998), at 598

condition.²⁴²⁴ According to Sections 237 and 238, performance or an offer of performance is a condition for the aggrieved party's remaining duty under the contract. A material failure delays reciprocal performance temporarily and discharges reciprocal performance permanently if the material failure is not cured during the time in which performance can occur.²⁴²⁵ The Restatement distinguishes between "partial" breach and "total" breach. If the failure to perform is material, the aggrieved party may suspend his performance or terminate the contract on the basis of whether the harm from the failure is curable.²⁴²⁶ A material failure to perform that is curable justifies suspending performance, but does not allow the aggrieved party to terminate the contract. A total breach, which means a material failure that is incurable or not cured in time, justifies the aggrieved party terminating a contract and entitles him to a claim for damages for total breach.²⁴²⁷ Section 236 (1) defines a claim for damages for total breach as "one for damages based on all of the injured party's remaining rights to performance." Section 242 lists circumstances to be considered in determining the period of time after which remaining duties are discharged, if a material failure has not been cured, i.e. circumstances that determine whether the uncured material failure constitutes a "total" breach. The list includes, in addition to those stated in Section 241, the extent to which it reasonably appears to the aggrieved party that delay may prevent or hinder him in making reasonable substitute arrangements, and the extent to which the agreement provides for performance without delay. In those cases, the aggrieved party may also choose to continue with the contract and claim damages for partial breach. Pursuant to Section 236 (2), a claim for damages for partial breach is defined as "one for damages on only part of the injured party's remaining rights to performance." If the aggrieved party elects to or is required to await the balance of the other party's performance under the contract, his claim is one for damages for partial breach; for example, an aggrieved party, who claims damages in addition to specific performance, claims damages for partial breach.²⁴²⁸

The Restatement directs the courts to consider the extent to which the aggrieved party has received the benefit that he expected from the contract in the determination of a material failure in performance.²⁴²⁹ Thus, there will be a material breach if a party has failed to perform substantially in terms of the contract. There is a tendency of the courts to refer to material breach and to substantial performance as opposite sides of the same coin.²⁴³⁰ The substantial performance rule contrasts with the perfect tender rule, which was developed with respect to contracts for the sale of goods during the nineteenth century under common law. Under the perfect tender rule, the buyer is free to reject the goods unless the tender conforms in every respect to the contract, including not only quantity and quality but also the details of shipment.

²⁴²⁴ Restatement (Second) of Contracts, Section 237, Comment a

²⁴²⁵ Ibid.

²⁴²⁶ Gergen, Mark P., *The Law's Response to Exit and Loyalty in Contract Disputes*, in Nili Cohen & Ewan McKendrick, *Comparative Remedies for Breach of Contract*, Oxford: Hart, 2005, at 77

²⁴²⁷ Restatement (Second) of Contracts, Sections 236, 243(1)-(2)

²⁴²⁸ Restatement (Second) of Contracts, Section 236, Comment b. The failure to perform may also be a breach and give rise to a claim for damages for partial breach, even if not material. Restatement (Second) of Contracts, Section 241, Comment a

²⁴²⁹ Restatement (Second) of Contracts, Section 237 Comment d; Section 241, Comment b

²⁴³⁰ Van Vuuren, Elbi Janse, *Termination of International Commercial Contracts for Breach of Contract: The Provisions of [South African Contract Law, U.S. Contract Law, German Contract Law and] the UNIDROIT Principles of International Commercial Contracts*, *Arizona Journal of International & Comparative Law*, 15 (1998), at 600

The perfect tender rule is adopted by the Article 2-601 of the Uniform Commercial Code. This constitutes an exception to the doctrine of substantial performance in a contract for the sale of goods in US law. Article 2-601 allows the buyer to reject a tender under a single delivery contract, if the goods or the tender of delivery fail in any respect to conform to the contract. Karl Llewellyn unsuccessfully proposed replacing the perfect tender rule with a substantial performance rule to govern sales of goods between merchants under the UCC. Llewellyn observed, from the practice, that merchants regularly make and accept deliveries of goods that vary in minor ways from the contract terms and arrange adjustments between themselves accordingly. He argued that under a substantial performance rule, the courts would be authorized to make the same kinds of adjustments; whereas, under a perfect tender rule, buyers would be free to take advantage of a falling market by rejecting an imperfect tender whenever the price of the goods had fallen since the time of purchase. In Llewellyn's view, the perfect tender rule would lead mercantile injustice by allowing a buyer in a falling market to reject deliveries "which in all mercantile decency could be expected as of course to fill the buyer's expectations."²⁴³¹

The perfect tender rule, however, is curtailed to a certain extent under the UCC. For example, Article 2-602 states that rejection of goods must be within a reasonable time after their delivery or tender, and rejection is ineffective unless the buyer seasonably notifies the seller. Moreover, Article 2-605 provides that the buyer's failure to notify a particular defect, which is ascertainable by reasonable inspection, precludes him from relying on the defect as a valid reason to reject the goods, where the seller could have cured it if stated seasonably. Furthermore, pursuant to Article 2-608(1), once the buyer has "accepted" the goods, he can only terminate ("revoke his acceptance") if the non-conformity of the goods "substantially" impairs their value. It is observed that, in practice, the courts readily hold that the buyer has accepted the goods so as to restrict the right of termination to cases of "substantial" impairment.²⁴³² The requirement of substantial impairment of value is also used by the UCC in Article 2-610, regarding anticipatory repudiation and Article 2-612 regarding the breach of installment contracts. As this requirement is similar to the common law standard of material breach, it is observed that the courts have used Section 241 of the Restatement (Second) of Contracts as a guideline to resolve if a breach is substantial.²⁴³³

The common law doctrine of anticipatory breach enables the aggrieved party to claim damages at the date of the acceptance of the breach, or to terminate the contract immediately before performance has actually become due.²⁴³⁴ However, the right of the aggrieved party to terminate the contract on the ground of the anticipatory breach does not arise merely because the breach is anticipatory. Other requirements of termination may have to be satisfied. Where the aggrieved party decides to terminate the contract, he must give notice to the party in breach that he accepts the anticipatory breach in definite and unequivocal terms, or he must

²⁴³¹ Wiseman, Zipporah Batshaw, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, Harvard Law Review, 100-3 (1987), at 510

²⁴³² Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tubingen: Mohr, 1976, at 132

²⁴³³ Pauly, Clemens, *The Concept of Fundamental Breach as an International Principle to Create Uniformity of Commercial Law*, Journal of Law and Commerce, (2000), at 228

²⁴³⁴ The origin of development of the anticipatory breach doctrine is usually associated with the English case, *Hochster v. De La Tour*, 118 Eng. Rep. 922 (Q.B. 1853) and the American case, *Masterton & Smith v. Mayor of Brooklyn*, 7 Hill 61 (N.Y. Sup. Ct. 1845)

otherwise provide overt evidence as to his acceptance of the breach by acting upon it prior to the time of performance that is due under the contract.²⁴³⁵ Article 2-610 of the UCC requires that the loss arising from a party's repudiation of the contract with respect to a performance not yet due must substantially impair the value of the contract to the aggrieved party. Similarly, under the Restatement, in order for a statement or an act to be an anticipatory breach, which enables the other party to terminate, the threatened breach must be of sufficient gravity that, if the breach actually occurred, it would of itself give the obligee a claim for damages for total breach.²⁴³⁶ In English law, a refusal to perform except in a defective manner will amount to an anticipatory breach provided that the defect is sufficiently serious, and in deciding this question, the same criteria are used as in deciding whether failure to perform justifies the other party to terminate the contract.²⁴³⁷

Under English law, a refusal to perform or deliberate breach of a minor obligation may also indicate an intention to refuse to perform substantial obligations in the future and will then justify termination for anticipatory breach, but it is submitted that termination will not be justified, if the refusal or breach that is confined to the minor obligation does not show a general intention to repudiate.²⁴³⁸ Thus, if the repudiation contained an element of equivocation or ambiguity, a question might arise as to whether termination was indeed justified.²⁴³⁹ For the latter kind of situations, Section 2-609 of the UCC provides that, when reasonable grounds for insecurity arise with respect to the performance of either party, the other may in writing demand adequate assurance of due performance and, until he receives such assurance, may suspend any performance for which he has not already received the agreed return. A party failing to timely comply with a reasonable demand for adequate assurances has committed an anticipatory breach on the basis of which the other party can immediately bring lawsuit.²⁴⁴⁰ The Restatement provides this mechanism where a party has reasonable grounds to believe that the obligor will commit a breach that would of itself give the obligee a claim for damages for total breach.²⁴⁴¹

Under common law, where a breach gives rise to a right in favor of the aggrieved party to terminate, that party has a choice whether to terminate or not.²⁴⁴² The aggrieved party is not

²⁴³⁵ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 398; Rowley, Keith A., *A Brief History of Anticipatory Repudiation in American Contract Law*, *University of Cincinnati Law Review*, 69 (Winter 2001), at 569

²⁴³⁶ Restatement (Second) of Contracts, Section 250, Comment d.

²⁴³⁷ Beale, Hugh. G., *Remedies for Breach of Contract*, London: Sweet & Maxwell, 1980, at 69. In *Decrowall International S.A. v. Practitioners in Marketing Ltd.* [1971] 1 W.L.R. 361, the likelihood that payment would continue to be made slightly late was held not to amount to a repudiation because it did not go to the root of the contract, and there was no doubt that the payments would ultimately be made.

²⁴³⁸ Beale, Hugh. G., *Remedies for Breach of Contract*, London: Sweet & Maxwell, 1980, at 70

²⁴³⁹ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 139

²⁴⁴⁰ Rowley, Keith A., *A Brief History of Anticipatory Repudiation in American Contract Law*, *University of Cincinnati Law Review*, 69 (Winter 2001), at 619

²⁴⁴¹ Restatement (Second) of Contracts, Section 251(1); This mechanism of adequate assurance is argued to be "the most innovative and commercially sensible development in contract law in [the twentieth] century." Robertson Jr., R.J., *The Right to Demand Adequate Assurance of Due Performance: Uniform Commercial Code Section 2-609 and Restatement (Second) of Contracts Section 251*, *Drake Law Review*, 38 (1988-1989), at 353

²⁴⁴² Ellington, Paul R., *Termination of Contracts under English Law*, *International Business Law Journal*, (1997), at 860

obliged to exercise his right to terminate the contract. He can either terminate the contract and claim damages, or affirm the contract and claim damages. The aggrieved party is not required to exercise his right of election between termination and affirmation immediately, but he must take reasonable steps to mitigate his loss.²⁴⁴³ Where the aggrieved party wishes to accept the breach and terminate the contract, he must communicate his decision to the other party. The act constituting the acceptance of a breach does not require a particular form, but it must clearly and unequivocally convey to the non-performing party that the aggrieved party is treating the contract as at an end.²⁴⁴⁴ A mere failure to perform will not constitute an acceptance of the breach in all cases. Whether an act constitutes an acceptance depends on the particular contractual relationship and the particular circumstances of the case.²⁴⁴⁵ If the aggrieved party does not terminate the contract, he is said to have affirmed the contract, but this will be without prejudice to his right to damages. Affirmation of a contract is only effective if the aggrieved party has knowledge of the facts establishing his right to terminate, knowledge of his right to terminate, and the affirmation is communicated to the other party.²⁴⁴⁶ If the aggrieved party affirms the contract, the contract remains in force, and both parties remain bound to continue with the performance of their respective contractual obligations. Once the aggrieved party has exercised his right of election and chosen either to terminate or to affirm, that decision cannot be revoked. The exercise of this right of election is also called “waiver by election”.²⁴⁴⁷

There are additional rules limiting the right to terminate, which aim at avoiding undue prejudice to the non-performing party, where he is led to believe that the remedy of termination will not be claimed.²⁴⁴⁸ Thus, the right to terminate the contract may be lost by “waiver by estoppel”. The waiver by estoppel arises when the aggrieved party represents clearly and unequivocally to the non-performing party that he will not exercise his right to terminate or behaves in a way that leads the non-performing party to believe that he will not exercise his right to terminate. In the case of waiver by estoppel, the aggrieved party’s knowledge of the circumstances or of the right is not required as the other party is entitled to rely on the apparent election conveyed by the representation. The waiver by estoppel may also amount to a complete waiver, including not only the right to terminate the contract, but also the right to claim damages.²⁴⁴⁹

In principle, under English law, the consequence of termination of the contract “does not involve an undoing of what has already been performed under the contract”.²⁴⁵⁰ There is a distinction between termination and rescission *ab initio*. The latter is the remedy available to the victims of such events as fraud, misrepresentation or undue influence, and has different

²⁴⁴³ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 394

²⁴⁴⁴ Lord Steyn in *Vitol SA v. Norelf Ltd* [1996] A.C. 800, at 810

²⁴⁴⁵ *Ibid.*, at 811

²⁴⁴⁶ Ellington, Paul R., *Termination of Contracts under English Law*, *International Business Law Journal*, (1997), at 860

²⁴⁴⁷ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 396

²⁴⁴⁸ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tubingen: Mohr, 1976, at 148

²⁴⁴⁹ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 396-397

²⁴⁵⁰ Atiyah, P. S., *An Introduction to the Law of Contract*, Clarendon Express (Oxford), 5th ed., 1995, at 410

consequences to termination for non-performance.²⁴⁵¹ Both rescission *ab initio* and termination releases both parties from their obligations to perform in the future. If a contract is effectively rescinded *ab initio* it is as if it had never existed: no action can be brought on it, and if the party, who was entitled to rescind, wishes to claim damages, he must claim in tort or under statute.²⁴⁵² In contrast, a contract which has been terminated does not cease to exist, and the court must take into consideration such contract terms that are intended to regulate the consequences of breach or termination. In cases of termination, while both parties are released from their “primary obligation” to perform, which are put to an end through termination, the party in breach, by legal implication, becomes subject to a “secondary obligation” to pay damages to the aggrieved party for the loss sustained by him in consequence of the breach. The damages are to be assessed by reference to those obligations which would have fallen due for performance at some time in the future.²⁴⁵³ The prospective nature of termination also means that, although the parties are discharged from the need to perform those obligations that would have fallen due after the date of termination, rights and obligations that have unconditionally accrued prior to termination remain enforceable. Whether or not a right has unconditionally accrued depends upon a range of factors, including the nature of the obligation, what performance has been rendered by each party, and whether the party seeking to enforce the obligation is in breach. In some cases, money and property may be conditionally transferred under a contract, so there is a contractual obligation to repay or return it upon termination.²⁴⁵⁴

In English law, in order to determine the rights to the restitution of benefits conferred under a contract terminated, it is necessary to distinguish cases in which money has been paid, in which property has been transferred and in which services have been performed. If money has been paid before the date of termination, and assuming that it was not paid as a deposit or on terms that it would be forfeited if the contract was not performed, the aggrieved party may recover that amount only where there has been “a total failure of consideration”. The concept of “consideration” in the restitutionary context has a different meaning from the consideration required by English law for the formation of a valid contract. In *Fibrosa Spolka Akcyjna v Fairbairn Lawson Combe Barbour Ltd.*, it is explained that in the context of restitution, it is not the promise which is referred to as the consideration, but the performance of the promise: the money was paid to secure performance and, if performance fails, the inducement which

²⁴⁵¹ Sir Owen Dixon explained the distinction in *McDonald v Dennys Lascelles Limited* as follows; “When one party to a simple contract, upon a breach by the other contracting party of a condition of the contract, elects to treat the contract as no longer binding upon him, the contract is not rescinded as from the beginning. Both parties are discharged from the further performance of the contract, but rights are not divested or discharged which have already been unconditionally acquired. Rights and obligations which arise from the partial execution of the contract and causes of action which have accrued from its breach likewise continue unaffected. When a contract is rescinded because of matters which affect its formation, as in the case of fraud, the parties are to be rehabilitated and restored, so far as may be, to the position they occupied before the contract was made. But when a contract, which is not void or voidable at law, or liable to be set aside in equity, is dissolved at the election of one party because the other has not observed an essential condition or has committed a breach going to its root, the contract is determined so far as it is executory only and the party in default is liable for damages for its breach.” (1933) 48 CLR 457, at 476–77

²⁴⁵² Beale, Hugh. G., *Remedies for Breach of Contract*, London: Sweet & Maxwell, 1980, at 104-105

²⁴⁵³ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 393

²⁴⁵⁴ In *Dies v. British and International Mining and Finance Corporation* [1939] 1 KB 724, at 743, Stable J observed that “to enable the seller to keep [the money] he must be able to point to some language in the contract from which the inference to be drawn is that the parties intended and agreed that he should”. Stable J determined that the payment was not a deposit. Therefore once the contract was discharged the seller had no contractual or other right to retain it. The seller had not earned the money in accordance with any contractual provision.

brought about the payment is not fulfilled.²⁴⁵⁵ Failure of consideration occurs where a party confers a benefit under a contract, which is initially valid but prematurely discharged for breach or by frustration, without receiving the counter-performance on which such conferral was premised. In such cases, the benefit conferred is recoverable under the law of restitution on the ground of failure of consideration.²⁴⁵⁶ Where the property is transferred or created pursuant to a contract, its title is generally not revested upon termination for breach, but it is possible to recover its value. In cases of services performed by the party in breach before the contract was terminated, the common law position has traditionally been that, unless the contract is severable into units each with its own price and it can be said that some units have been performed, the party in breach gets nothing.²⁴⁵⁷ However, it has been held that the aggrieved party can become liable to pay for what he has received, if he makes a “fresh contract” with a third party on the same subject matter by “voluntarily accepting” the benefit.²⁴⁵⁸ On the other hand, the aggrieved party may recover a reasonable sum for his services rendered under the contract.²⁴⁵⁹ Finally, although the common law systems do not distinguish sharply between instantaneous and long term contracts in the context of termination, they reach results which are very similar to those reached in the civil law systems in cases involving contracts of the latter kind.²⁴⁶⁰ For example, in cases of contracts which are long-term or relational in their nature, including hire, joint ventures and commercial supply arrangements, failure of consideration will rarely be arguable, since the assumption tends to be that the right to keep the benefit of prior performances has been earned.²⁴⁶¹

In US law, where there is a breach of contract permitting the aggrieved party to terminate, that party may exercise the option of the remedy of restitution instead of claiming damages for total breach.²⁴⁶² Thus, the aggrieved party has an additional remedial option after justifiably

²⁴⁵⁵ Viscount Simon LC’s statement in [1943] AC 32 at 48

²⁴⁵⁶ Hutton, Sally J., *Restitution after Breach of Contract: Rethinking the Conventional Jurisprudence*, Acta Juridica, (1997), at 203. For example, in *Giles v Edwards*, (1797) 7 Term Rep 181, the plaintiff had contracted to buy wood from the defendant. It was a term of the contract that the defendant would cord the cut wood before delivery. The plaintiff paid the contract price in advance but the defendant only corded a small portion of the wood. Accordingly, the plaintiff terminated the contract and was held entitled to recover the money it had paid on the ground of failure of consideration.

²⁴⁵⁷ Beale, Hugh G., *Remedies: Termination*, in Arthur Hartkamp, Martijn Hesselink, Ewoud Hondius, Carla Joustra & Edgar du Perron (eds.), *Towards A European Civil Code*, Kluwer Law International, 2nd ed., 1998, at 356

²⁴⁵⁸ Beale, Hugh G., *Remedies for Breach of Contract*, London: Sweet & Maxwell, 1980, at 111-112; In *Sumpter v. Hedges* [1898] 1 Q.B. 673, CA, Sumpter was employed to build on Hedge’s land under a lump sum contract, but abandoned the contract after doing part of the work. Hedge finished off the work using materials left on the site by a third party. This was held not to constitute voluntary acceptance of the work, as Hedge had no practical choice but to accept it, but Hedge was found liable to pay a reasonable sum for the materials as these he could have returned.

²⁴⁵⁹ In both *Lodder v Slowey* [1904] AC 442 and *Chandler Bros Ltd v Boswell* [1936] 3 All ER 179 the plaintiff was awarded a quantum meruit for the value of the work he had done in part performance of a construction contract which had been prematurely terminated for the employer’s breach.

²⁴⁶⁰ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tubingen: Mohr, 1976, at 141-142

²⁴⁶¹ McMeel, G.P., *Unjust Enrichment, Discharge for Breach, and the Primacy of Contract*, in Andrew Burrows & Lord Rodger of Earlsferry (Eds.), *Mapping the Law: Essays in Memory of Peter Birks*, Oxford University Press, 2006, at 233-234

²⁴⁶² The aggrieved party may not combine the remedy of restitution with that of damages for total breach, as they are inconsistent. However, a party who seeks restitution may, for example, be entitled to damages to compensate

terminating the primary obligations, and instead of seeking the substituted value of the other party's promised performance, the aggrieved party may seek to recover the value of any performance it rendered to the other party prior to the breach.²⁴⁶³ Section 373 (1) of the Restatement provides that on a breach by non-performance that gives rise to a claim for damages for total breach or on a repudiation, the aggrieved party is entitled to restitution for any benefit that he has conferred on the other party by way of part performance or reliance. However, under Section 373 (2), the aggrieved party has no right to restitution if he has performed all of his duties under the contract and no performance by the other party remains due other than payment of a definite sum of money for that performance. In such cases, the aggrieved party is barred from recovery of a greater sum as restitution by Section 373 (2) than the sum of money that has been fixed as the price. Since the aggrieved party is entitled to recover the price in full together with interest, he is considered as having a remedy that protects his expectation interest by giving him the very thing that he was promised. The same rule applies to a contract which is "divisible" in the sense that parts of the performances to be exchanged on each side are properly regarded as a pair of agreed equivalents.²⁴⁶⁴ Section 371 provides flexibility in fitting the measure of recovery to the particular case by stating that "as justice requires" the measure of recovery is either the market value of the plaintiff's performance or the "extent to which the other party's property has been increased in value or his other interests advanced."²⁴⁶⁵ Finally, Section 374 (1) provides that the party in breach is also entitled to restitution of "any benefit he has conferred by way of part performance or reliance in excess of the loss that he has caused by his own breach" whether or not his breach was willful. However, specific restitution, while accessible to the aggrieved party unless in the discretion of the court it would "unduly interfere with the certainty of title to land or otherwise cause injustice", is not available to the party in breach under Section 372 (1) (b).

b. International Instruments

The concept of "fundamental breach" constitutes the basis of "avoidance", i.e. termination, of the contract, under the CISG. As termination has severe economic consequences for the defaulting party who has prepared his performance in the context of international contracts, the CISG require that non-performance be fundamental in order for the aggrieved party to avoid the contract under Articles 49 (1) (a) and 64 (1) (a).²⁴⁶⁶ While a general breach entitles the aggrieved party to claim damages, the party is entitled to the remedy of contract avoidance if he can prove that the breach is fundamental. Under Article 25 of the CISG, a breach is fundamental when it results in such detriment to the aggrieved party as substantially to

him for costs of transportation of goods that he has incurred. See Restatement (Second) of Contracts, Section 378, Comment d.

²⁴⁶³ Gegan, Bernard E., In Defense of Restitution: A Comment on Mather, Restitution as a Remedy for Breach of Contract, The Case of the Partially Performing Seller, Southern California Law Review, 57 (1983-1984), at 723-724

²⁴⁶⁴ Restatement (Second) of Contracts, Section 373, Comment c.

²⁴⁶⁵ Perillo Joseph M., Restitution in the Second Restatement of Contracts, Columbia Law Review, (January 1981), at 47

²⁴⁶⁶ The concept of fundamental breach is also used to deal with avoidance in special situations, namely in Article 51(2) of the CISG on avoidance of an entire contract based on defective performance of a part of the contract, in Article 72 on anticipatory breach, and in Article 73 on deliveries by installments. Finally, it is used in Article 46(2) to limit the remedy of specific performance; the buyer "may require delivery" of goods to substitute for nonconforming goods "only if the lack of conformity constitutes a fundamental breach of contract."

deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result.²⁴⁶⁷

Article 25 of the CISG provides a two-part test, which aims at balancing the interests of both parties.²⁴⁶⁸ First, the decision maker should scrutinize the breach according to the substantial detriment test. There will be a fundamental breach of contract, which justifies avoidance, if the aggrieved party has no further interest in the performance of the contract after the breach.²⁴⁶⁹ The determination of this interest depends on the terms of the individual contract, whether express or implied, and reasonable expectations of the parties under the circumstances of a particular case. Secondly, the decision maker should deal with the issue of foreseeability. Article 25 only applies when the party in breach had or ought to have foreseen the substantially detrimental result of the breach of contract. Thus, the decision maker should hypothesize a reasonable person engaged in the same line of trade, exercising the same function, and take into account the whole socio-economic background.²⁴⁷⁰ This test allows the party in breach to escape the determination of fundamental breach and its consequences by proving that he did not foresee the substantially detrimental result, and that a reasonable person could not have foreseen it.²⁴⁷¹ Although Article 25 does not expressly state the time when the party in breach had to foresee or should have foreseen the detrimental consequences, it is generally argued that the relevant point in time at which the consequences of the breach must have been foreseeable is the time of the conclusion of the contract.²⁴⁷²

Under the Article 26 of the CISG, the avoidance must be declared by the aggrieved party in a notice to the party in breach. Thus, under Article 49, which allows a buyer to declare the, and under Article 64, which permits the seller to declare avoidance under certain specified circumstances, the avoidance of the contract is conditioned on a declaration of avoidance by the buyer or seller.²⁴⁷³ A buyer's declaration of avoidance must inform the seller that the buyer will not accept or keep the goods, while a seller's declaration of avoidance must inform

²⁴⁶⁷ This formulation reflects the approach of the US Uniform Commercial Code, which confers upon the buyer a right to revoke acceptance of merchandise "whose non-conformity substantially impairs its value to him" under Article 2-608(1), or which applies a stricter, less subjective standard to installment contracts under Article 2-612(2) and (3). Moreover, the formula seems to have been inspired by Lord Diplock's test in *Hong Kong Fir Shipping Co. Ltd. v. Kawasaki Kisen Kaisha, Ltd.*: "does the occurrence of the event deprive the party ... substantially the whole benefit which it was the intention of the parties as expressed in the contract that he should obtain ... ?" [1962] 2 Queen's Bench 26; [1962] All England Reports 474

²⁴⁶⁸ Pauly, Clemens, *The Concept of Fundamental Breach as an International Principle to Create Uniformity of Commercial Law*, *Journal of Law and Commerce*, (2000), at 225

²⁴⁶⁹ Will, Michael, Article 25, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 214

²⁴⁷⁰ Farnsworth, E. Allan, Article 8, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 98

²⁴⁷¹ Will, Michael, Article 25, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 216-217

²⁴⁷² Lando Ole, *Termination for Breach of Contract in the CISG, the Principles of European contract law, the UNIDROIT Principles of international commercial contracts*, in K. Boele-Woelki and F.W. Grosheide (eds.), *The Future of European Contract Law, Liber Amicorum E.H. Hondius*, Kluwer International, 2007, at 198; Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 59

²⁴⁷³ Date-Bah, Samuel K., Article 26, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 222

the buyer that the seller will not deliver the goods or, if the goods have been delivered, that the seller demands their return.²⁴⁷⁴

Article 49 of the CISG contains the buyer's remedy of avoidance of the contract. Article 49(1) envisages two situations, which entitle the buyer to terminate the contract. First situation is that the failure by the seller to perform any of his obligations under the contract or the Convention amounts to a fundamental breach of contract. Second situation occurs when the seller's failure to deliver the goods, although not amounting to a fundamental breach of contract, continues within the additional period of time fixed by the buyer in accordance with Article 47 (1), or the seller declares that he will not deliver within the period so fixed.²⁴⁷⁵ Thus, the failure of the seller to deliver goods, when it is not a fundamental breach, leads to a Nachfrist mechanism. Only in the case of non-delivery, the CISG allows the buyer to transform a non-fundamental breach of contract into a fundamental breach by fixing an additional period of time for performance.²⁴⁷⁶ This protects the interests of the seller as it would be too harsh for him to lose the benefits of the whole contract on account of insignificant shortcomings.²⁴⁷⁷ Moreover, Article 45(3) states that no period of grace may be granted to the seller by a court or arbitral tribunal when the buyer resorts to a remedy for breach of contract. It is explained that, since the CISG does not provide a procedure of applying to a court for avoiding the contract, there is no room for such an additional period to be granted by a court.²⁴⁷⁸

Article 49 (2) declares the buyer's remedy of avoidance lost if the seller actually delivered the goods and the buyer hesitated too long before declaring the contract avoided.²⁴⁷⁹ The article aims at removing the risks of needless costs of the care and return of the goods, which could result from the undue delay of the buyer in declaring avoidance of the contract, and avoiding

²⁴⁷⁴ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 213-214

²⁴⁷⁵ Article 47 (1) authorizes the buyer to "fix an additional period of time of reasonable length for the performance by the seller of his obligations". When the buyer actually fixes such a period of time, Article 47 (2) prevents the buyer from resorting to the remedy of avoidance, unless the buyer has received notice from the seller that he will not perform within the period so fixed.

²⁴⁷⁶ At the Vienna Conference the proposal to extend the procedure of fixing an additional period of time as a condition for avoidance to all material obligations was rejected. The First Committee felt that the buyer should not be authorized to take advantage of minor shortcomings by transforming them into fundamental breaches in order to get out of the contract whenever the market fell. Will, Michael, Article 49, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 360

²⁴⁷⁷ *Ibid.*, at 363

²⁴⁷⁸ Will, Michael, Article 48, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 331

²⁴⁷⁹ Other circumstances under which the buyer loses his right to avoid the contract are defined in Article 39, which obliges the buyer who has received non-conforming goods to give notice of the lack of conformity to the seller in due time, Article 43, which obliges the buyer who has received goods which are not free from third party claims to notify the seller in due time, and Article 82, which prevents the buyer from avoiding the contract when the buyer is unable to reconstitute the goods substantially in the condition in which he received them and cannot rely on the three exceptions provided. All of these rules presuppose that the seller has delivered. Will, Michael, Article 49, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 366; However, there are hesitations with regard to such effect of Articles 39 and 43 on the buyer's remedy of avoidance, where a seller knows of the defect of which the buyer would otherwise be required to give notice. Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 331

the buyer's speculation at the seller's risk when the price of the goods is subject to market fluctuations.²⁴⁸⁰ Thus, Article 49 distinguishes between the obligation to deliver and obligations other than delivery. As soon as delivery has been made, if the buyer wants to reject it, he is obliged to declare the contract avoided within a reasonable time after he has become aware of the delivery. In cases of fundamental breach of any of the seller's obligations other than delivery, the buyer will lose his right to reject the goods and to declare the contract avoided unless he does so within a reasonable time under the particular circumstances.

Article 64 of the CISG provides the seller's remedy of avoidance of the contract. It distinguishes between the situation, where the buyer fails to perform any obligation under the contract or the Convention and his failure amounts to a fundamental breach of contract, and the situation, where the buyer fails to perform either his obligation to pay the price or his obligation to take over the goods, or he declares that he will not do so, within the additional period of time fixed by the seller in accordance with Article 63 (1).²⁴⁸¹ Article 64 (2) provides that the seller's remedy of avoidance is lost if the buyer has actually paid the price and the seller did not declare the contract avoided within a reasonable time under the particular circumstances. This implies that the seller retains the right to avoid the contract without regard to those time limits only as long as the price remains unpaid.²⁴⁸² However, once the price has been paid, even if the buyer has committed a fundamental breach of the contract, the seller cannot wait and watch market developments before making his decision to avoid the contract.²⁴⁸³ Article 64(2) distinguishes between two different situations, namely late performance by the buyer of any of his obligations, and any breach other than late performance by the buyer. In case of late performance by the buyer, the seller should avoid the contract before he has become aware that performance has been rendered, in order not to lose the right to declare the contract avoided. In other cases of non-performance, the seller should declare the contract avoided within a reasonable time, after he knew or ought to have known of the breach, after any additional time period allowed for performance was expired, or after the buyer has declared that he will not perform his obligations.

Article 72 of the CISG provides for a contract to be avoided for an anticipatory breach. Article 72 (1) provides that if prior to the date for performance of the contract it is clear that one of the parties will commit a fundamental breach of contract, the other party may declare the contract avoided. Article 72 (2) requires, if time allows, the party intending to declare the contract avoided to give reasonable notice to the other party in order to permit him to provide adequate assurance of his performance. The absence of an assurance of performance in response to such a notice would make it clear that a breach is going to occur. In cases where there is no time to notify, or where the delivery date is so near that assurances could not be procured in time, there is no need to notify the other party.²⁴⁸⁴ While Article 72 allows the

²⁴⁸⁰ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 332

²⁴⁸¹ *Ibid.*, at 386: Failure to comply with the Nachfrist notice provides a basis for avoidance only when the notice calls for performance of the buyer's basic obligations "to pay the price or to take delivery of the goods". The buyer's "obligation to pay the price" includes the required steps "to enable payment to be made", pursuant to Article 54.

²⁴⁸² Knapp, Victor, Article 64, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 469

²⁴⁸³ Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 84

²⁴⁸⁴ *Ibid.*, at 95

avoidance of the existing contract, so that another one can be expeditiously entered into, and uncertainty with respect to financial commitments can be removed, Article 71 allows a party to suspend the performance of his obligations in cases of anticipatory breach.²⁴⁸⁵ However, Article 72 contains a stricter requirement for its invocation by allowing a party to declare the contract avoided on the condition that, prior to the date for performance of the contract, it is *clear* that the other party will commit a fundamental breach of contract, than Article 71, which allows a party to suspend the performance of his obligations on the condition that, after the conclusion of the contract, it becomes *apparent* that the other party will not perform a substantial part of his obligations.

The consequences of avoidance are provided in Articles 81-84 of the CISG. Article 81 sets forth the two consequences which result from the avoidance of the contract. First, under Article 81 (1), avoidance of the contract releases both parties from their obligations prospectively, subject to any damages which may be due. Moreover, the second sentence of Article 81(1) explicitly states that the avoidance does not affect any provisions of the contract for the settlement of disputes, such as arbitration and renegotiation clauses, or any other provision of the contract governing the rights and obligations of the parties consequent upon the avoidance of the contract, such as penalty or liquidated damages clauses and clauses restricting or excluding liability. Secondly, under Article 81 (2), a party who has performed the contract either wholly or in part may claim restitution from the other party of whatever the first party has supplied or paid under the contract, and if both parties are bound to make restitution, they must do so concurrently. Thus, Article 81(2) provides the retrospective effect of the avoidance of the contract. However, the parties' actions of restitution are to be governed by the applicable law. Thus, where specific performance is limited under the applicable law, restitution in kind will be difficult to obtain. The party in breach will be liable for all the expenses consequent to the restitutions, because of the principle that damages are designed to compensate the aggrieved party for the entire loss he has suffered as a result of the breach, pursuant to Article 74.²⁴⁸⁶

Article 82 provides a limitation on the right to declare the contract avoided when the buyer is unable to return the goods substantially in the conditions in which he received them. This limitation is criticized on the basis of the experience with German law, where it caused important problems and scholarly controversies before the reform.²⁴⁸⁷ However, it is argued that this limitation does not lead to serious injustice to an aggrieved buyer since even if the buyer may not avoid the contract, he may recover damages resulting from the seller's breach of contract.²⁴⁸⁸ Article 83 explicitly provides that the loss of the right to declare the contract avoided does not deprive the buyer of the right to claim other remedies which are available under the contract and the Convention. Moreover, it is pointed out that the failure of restituting the goods is defined by the Convention in a flexible way thereby allowing the decision maker to exercise his discretion in determining whether the goods returned can be

²⁴⁸⁵ Bennett, Trevor, Article 72, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 527

²⁴⁸⁶ Tallon, Denis, Article 81, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 604

²⁴⁸⁷ Schlechtriem, Peter, *Termination of Contracts under the Principles of International Commercial Contracts*, in Michael Joachim Bonell & Franco Bonelli (eds.), *Contratti commerciali internazionali e Principi UNIDROIT*, Giuffrè, Milano 1997, at 268

²⁴⁸⁸ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 509

regarded as substantially in the same conditions in which the buyer received it.²⁴⁸⁹ There are also several exceptions to this rule. First, the buyer retains the right to declare the contract avoided if the impossibility to restitute the goods “is not due to his act or omission”. The second exception deals with the situation in which the goods have perished or deteriorated as a result of the examination provided for in Article 38. Thirdly, the buyer retains the right to declare the contract avoided, if the goods or part of the goods have been sold in the normal course of business or have been consumed or transformed by the buyer in the course of normal use before he discovered or ought to have discovered the lack of conformity.

Article 84 requires the parties to return all benefits of possession. The first paragraph states that where the seller is under obligation to refund the price, he must pay interest from the date of payment. The second paragraph provides that the buyer must account to the seller for all the benefits which he has derived from the goods or part of them. The buyer has to return benefits which he has derived from the goods if the buyer must make restitution of the goods or part of them, or if it is impossible for him to make restitution of all or part of the goods substantially in the condition in which he received them, but he has nevertheless declared the contract avoided or required the seller to deliver substitute goods. Given the absence of any precision in the article concerning the mode of assessment of this benefit, the matter is governed by the applicable national law on restitution.²⁴⁹⁰

As avoidance terminates the rights and duties of both parties to proceed further with performance, subject to a claim for damages for breach of contract, and gives rise to restitutionary duties for both parties, the remedy of contract avoidance is considered as a remedy of last resort.²⁴⁹¹ In this regard, the relationship between the buyer’s right to terminate the contract for defective performance and the seller’s right to cure defective performance has a particular importance. Article 48, which regulates the seller’s right to cure, by reserving Article 49, appears to underline the priority of the buyer’s remedy of avoidance over the seller’s right to cure. However, the relationship between Article 48 and 49 remains largely unsettled, and requires the decision makers to strike a balance between the competing interests of the buyer and the seller.²⁴⁹²

It is argued that the seller’s right to cure under Article 48, being more specific than the general right to avoid the contract, prevails over the buyer’s right to avoid the contract. According to this view, in determining the existence of a fundamental breach, the decision

²⁴⁸⁹ Tallon, Denis, Article 82, Schlechtriem, Peter, Termination of Contracts under the Principles of International Commercial Contracts, in Michael Joachim Bonell & Franco Bonelli (eds.), *Contratti commerciali internazionali e Principi UNIDROIT*, Giuffrè, Milano 1997, at 607

²⁴⁹⁰ Tallon, Denis, Article 84, Schlechtriem, Peter, Termination of Contracts under the Principles of International Commercial Contracts, in Michael Joachim Bonell & Franco Bonelli (eds.), *Contratti commerciali internazionali e Principi UNIDROIT*, Giuffrè, Milano 1997, at 611

²⁴⁹¹ Pauly, Clemens, The Concept of Fundamental Breach as an International Principle to Create Uniformity of Commercial Law, *Journal of Law and Commerce*, (2000), at 225; German Federal Supreme Court, VIII ZR 51/95, 3 April 1996 (Cobalt sulphate case): Avoidance a “last resort”, breach must “substantially deprive party of what he was entitled to expect; Buyer could use defective goods or resell; avoidance denied. CLOUT 171, UNILEX D.1996.4. Germany, Provincial Court of Appeal, Frankfurt a. M., 5 U 15/93, 18 January 1994 (Shoes case); goods must be unfit for use, Buyer could readily resell, though at a discount. Avoidance denied. CLOUT 79, UNILEX D.4. Switzerland, Commercial Court, Zürich, 920670, 26 April 1995 (Saltwater isolation tank case); Buyer could repair leaky tank. UNILEX D. 1995-15.1.

²⁴⁹² Will, Michael, Article 48, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 348

maker should take into account whether the seller will cure, where cure is feasible and where an offer of cure can be expected, given that the decision on the fundamental breach should be made in the light of all of the circumstances.²⁴⁹³ However, the buyer's need for a prompt and clear answer to this question is emphasized in view of the fact that any uncertainty would be at the risk of the asking buyer until the answer arrives. Thus, it is argued that the buyer who has already suffered the seller's fundamental breach of contract should not, in addition, be burdened with the entire range of uncertainties as to the same seller's ability and willingness to cure. It is suggested that the buyer should not be required to delay avoidance of the contract unless the question of whether the seller will cure is answered affirmatively based on the buyer's actual knowledge, such as prior experience with the seller, an ad hoc commitment or the underlying general conditions of sale.²⁴⁹⁴ Moreover, Article 48 (2) provides that if the seller requests the buyer to make known whether he will accept cure and the buyer does not comply with the request within a reasonable time, the seller may perform within the time indicated in his request, and the buyer may not, during that period of time, resort to avoidance or any remedy which is inconsistent with performance by the seller. The underlying idea is that the buyer deserves protection only when he is cooperative and gives the seller a fair chance.²⁴⁹⁵ Thus, it is observed that some national courts applying the CISG have been reluctant to consider a breach to be fundamental when the goods can be repaired and the seller offers and makes a speedy repair without any inconvenience to the buyer.²⁴⁹⁶

The avoidance of contract for non-performance under the CISG has greatly influenced the approach of the UNIDROIT Principles to the issue of termination for non-performance. Articles 7.3.1, 7.3.3 and 7.3.4 of the UNIDROIT Principles entitle the aggrieved party to terminate the contract for actual or anticipatory non-performance.²⁴⁹⁷ Termination under those

²⁴⁹³ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 320-321

²⁴⁹⁴ Will, Michael, Article 48, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 351

²⁴⁹⁵ *Ibid.*, at 354

²⁴⁹⁶ Lando Ole, *Termination for Breach of Contract in the CISG, the Principles of European contract law, the UNIDROIT Principles of international commercial contracts*, in K. Boele-Woelki and F.W. Grosheide (eds.), *The Future of European Contract Law, Liber Amicorum E.H. Hondius*, Kluwer International, 2007, at 201

²⁴⁹⁷ It should be noted that the Working Group with the task of preparing a third edition of the UNIDROIT Principles attempted to draft new provisions on termination of long-term contracts for just cause. UNIDROIT 2006 - Study L - Doc. 99, March 2006, at 3-4; The draft rules would address the long-term contracts, particularly "relational" contracts, which are susceptible to supervening circumstances, whether caused by either party's fault or not, which make the continuation of the relationship no longer be acceptable to one or all of the parties involved. Under such rules, if such a contingency arises, the parties would be permitted to terminate the contract. However, already in the discussions of the Working Group, the necessity of such provisions was questioned in view of the contractual practice, which often regulates this issue by terms of the contract and, thus, it is argued that the issue could in most cases be disposed of by mere interpretation of the contract according to the general principle of good faith. UNIDROIT 2006 - Study L - Misc. 26, October 2006, at 38; During the discussions, it was pointed out that, in international contract practice, the hardship clauses normally have a much wider scope than the provisions on hardship contained in the Principles, and include the kind of circumstances relevant to the proposed provision on termination for just cause. UNIDROIT 2006 - Study L - Misc. 26, October 2006, at 39; Some members of the Working Group were of the opinion that the relevant issues are already covered by specific provisions of the Principles, such as Article 7.3.1 or Article 7.3.4. UNIDROIT 2008 - Study L - Misc.28, (26 - 29 May 2008), at 67; Even so, there was a general interest in the topic and it was decided to proceed with drafting of the relevant provisions. UNIDROIT 2006 - Study L - Misc. 26, October 2006, at 43; In the discussions, it was recalled that the topic was specifically addressed by the German reform of the law of obligations, and in Section 314 of the German Civil Code. It was generally felt that the draft rule on the topic should be modeled after the German rule as a very useful term of reference. However, as the proposed rule

provisions is explicitly stated as exceptions to the basic principle of *pacta sunt servanda* under Article 1.3.²⁴⁹⁸ The Official Comment to Article 7.3.1 states that it is necessary to take a restrictive approach to the right of termination as a result of the balancing of different considerations, namely the need to allow the aggrieved party to terminate the contract in certain cases, and the fact that this may cause serious detriment to the non-performing party that may incur expenses in preparing and tendering performance which cannot be recovered.²⁴⁹⁹ The Official Comment mentions the preservation of the contract and the minimization of economic waste as general policies of the Principles.²⁵⁰⁰ Thus, Chapter 7 combines three mechanisms, which are relevant to the remedy of avoidance under the CISG: the concept of fundamental breach, the *Nachfrist* mechanism, and the right of the non-performing party to cure.

Article 7.3.1 (1) of the UNIDROIT Principles provides that a party may terminate the contract where the failure of the other party to perform an obligation under the contract amounts to a fundamental non-performance. Article 7.3.1 does not give a definition of “fundamental non-performance”.²⁵⁰¹ Article 7.3.1 (2) provides a non-exhaustive list of factors to be considered in the determination of whether a particular non-performance amounts to a fundamental non-performance. First, under Article 7.3.1 (2) (a), regard is to be had to whether the non-performance substantially deprives the aggrieved party of what it was entitled to expect under the contract unless the other party did not foresee and could not reasonably have foreseen such result. This is clearly modeled upon the definition of fundamental breach under Article 25 of the CISG, which provides the two-part test. The only difference between Article 7.3.1 (2) (a) of the UNIDROIT Principles and Article 25 of the CISG is that the breach must have resulted in a “detriment” to the aggrieved party according to the wording of the CISG. This difference does not have any practical consequences, since the crucial element of Article 25 of the CISG is the “substantial deprivation” test, according to which the emphasis is not on the extent of the damage caused, but rather on the legitimate interests of the aggrieved party. Moreover, if the aggrieved party is substantially deprived of what it was entitled to expect under the contract, this alone constitutes a “detriment”.²⁵⁰² Second factor to be taken into account in the determination of fundamental non-performance is whether strict compliance

would lead to another departure from the general principle *pacta sunt servanda*, it was deemed necessary to provide safeguards against abuses of the remedy and to avoid overlapping with the provisions on hardship. Thus, the draft rules on termination for just cause attempted to specify the provision’s scope of application with regard to the relevant contracts and the concept of “just cause” as clearly as possible. UNIDROIT 2009 - Study L - Doc. 109, Rome, 26-29 May 2008, at 4-5; As to the effect of termination for just cause, it was stated that it entails the end of the contractual relationship for the future only without retrospective effect. It was also mentioned that the parties may still be under a duty to liquidate their relationship, for example by disclosing the relevant accounts and inventory. UNIDROIT 2009 - Study L - Doc. 109, Rome, 26-29 May 2008, at 8; The expectation of the competent organs of the UNIDROIT was that work on the new edition of the Principles should have been completed by 2010, while the draft chapter on termination of long term contracts for just cause only had a first reading by 2010. Thus, the Working Group decided that the draft has been put on hold to be taken up again in one way or another in the near future, possibly in an even broader context. UNIDROIT 2009 - Study L - Misc. 29, at 17-18

²⁴⁹⁸ Official Comment 2 to Article 1.3 of the UNIDROIT Principles

²⁴⁹⁹ Official Comment 2 to Article 7.3.1 of the UNIDROIT Principles

²⁵⁰⁰ Official Comment 1 to Article 7.1.4 of the UNIDROIT Principles

²⁵⁰¹ The Official Comment simply states that a non-performance is fundamental if it is “material and not merely of minor importance.” Official Comment 2 to Article 7.3.1 of the UNIDROIT Principles

²⁵⁰² Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 821-822

with the obligation, which has not been performed, is of essence under the contract, pursuant to Article 7.3.1(b). The Official Comment states that this factor is not interested in the actual gravity of the non-performance but in the nature of the contractual obligation for which strict performance might be of essence.²⁵⁰³ The third factor, under Article 7.3.1(2)(c), requires the consideration of whether the non performance is intentional or reckless. The Official Comment explains that it may be contrary to good faith to terminate a contract if the non-performance, even though committed intentionally, is insignificant.²⁵⁰⁴ Fourthly, pursuant to Article 7.3.1(2)(d), it should be considered whether the non performance gives the aggrieved party reason to believe that it cannot rely on the other party's future performance.²⁵⁰⁵ Linking this factor to the third one, the Official Comment states that sometimes an intentional breach may show that a party cannot be trusted.²⁵⁰⁶ Fifthly, under Article 7.3.1(e), regard should be had to whether the non performing party will suffer disproportionate loss as a result of the preparation or performance if the contract is terminated. This factor is a countervailing circumstance against the characterization of non-performance as fundamental and based upon the reliance of the non-performing party. The Official Comment states that non-performance is less likely to be treated as fundamental if it occurs late, after the preparation of performance, than if it occurs early before such preparation.²⁵⁰⁷

Article 7.3.1(3) introduces the mechanism of Nachfrist for the cases of delay in performance, which does not amount to a fundamental non-performance in the sense of Article 7.3.1(1) and (2).²⁵⁰⁸ Article 7.3.1 (3) provides that “In the case of delay the aggrieved party may also terminate the contract if the other party fails to perform before the time allowed it under Article 7.1.5 has expired.” Article 7.1.5 (3) provides that, in a case of delay in performance which is not fundamental, the aggrieved party may give notice allowing an additional period of time of reasonable length and it may terminate the contract at the end of that period. If the additional period allowed is not of reasonable length it shall be extended to a reasonable length. It is also provided that the aggrieved party may in its notice provide that if the other party fails to perform within the period allowed by the notice, the contract shall automatically terminate. Under Article 7.1.5 (4), the possibility to obtain a right to terminate the contract by using the Nachfrist mechanism is excluded if the obligation which has not been performed is only a minor part of the entire contractual obligation. However, it should be noted that termination through Nachfrist mechanism is limited to cases of delay. In other cases of non-performance, fixing an additional period of time for performance under Article 7.1.5, which applies to every kind of nonperformance, may only be relevant to the doctrine of fundamental non-performance under Article 7.3.1: for instance, as fixing an additional period of time for performance may help to clarify the questions of whether the non-performance is intentional or reckless, or whether the non performance gives the aggrieved party reason to believe that it cannot rely on the other party's future performance.

²⁵⁰³ Official Comment 3 (b) to Article 7.3.1 of the UNIDROIT Principles; This reflects similarities to the classification of a contractual term as a “condition” under English law. There are also parallels to the American concept of “total breach” as described in the Restatement (Second), Contracts.

²⁵⁰⁴ Official Comment 3 (c) to Article 7.3.1 of the UNIDROIT Principles

²⁵⁰⁵ This is similar to Article 73(2) of the CISG, which allows the avoidance of the installment contract for the future if there are good grounds to believe that a fundamental breach will occur with respect to future installments.

²⁵⁰⁶ Official Comment 3 (d) to Article 7.3.1 of the UNIDROIT Principles

²⁵⁰⁷ Official Comment 3 (e) to Article 7.3.1 of the UNIDROIT Principles

²⁵⁰⁸ Official Comment 4 to Article 7.3.1 of the UNIDROIT Principles

Article 7.1.4 contains the third mechanism used to restrict the availability of termination as a remedy. As opposed to the *Nachfrist* technique, this mechanism is not triggered by the aggrieved party, but by the non-performing party that wants to keep the contract alive. It provides that, if certain conditions are met, the non-performing party may cure by correcting the non-performance. Pursuant to Article 7.1.4 (1), the non-performing party may, at its own expense, cure any non-performance, provided that (a) without undue delay, it gives notice indicating the proposed manner and timing of the cure; (b) cure is appropriate in the circumstances; (c) the aggrieved party has no legitimate interest in refusing cure; and (d) cure is effected promptly. Thus, subject to those conditions, the non-performing party is able to extend the time for performance for a brief period beyond that stipulated in the contract, unless timely performance is required by the agreement or the circumstances.²⁵⁰⁹ Consequently, this mechanism enables the non-performing party to prevent termination by performing properly within a reasonable period of time and under adequate circumstances. In Article 7.1.4 (3), it is explicitly stated that upon effective notice of cure, those rights of the aggrieved party that are inconsistent with the non-performing party's performance are suspended until the time for cure has expired. Further, Article 7.1.4 (2) provides that the right to cure is not precluded by notice of termination. The Official Comment states that "If the aggrieved party has rightfully terminated the contract ... the effects of termination ... are also suspended by an effective notice of cure. If the non-performance is cured, the notice of termination is inoperative."²⁵¹⁰ Thus, the non-performing party may cure its non-performance even after a notice of termination by the aggrieved party and revive a contract that has been formally terminated by offering cure and performing properly. The latter is a far reaching rule, which aims at restricting the termination of the contract and cannot be found under the CISG or the PECL.²⁵¹¹

The right of a party to terminate the contract is exercised by notice to the other party, pursuant to Article 7.3.2 (1). This provision makes it clear that, in principle, there is no *ipso facto* termination of the contract, even if all the requirements are met. Article 7.3.2 (2) regulates time limits for the exercise of the right to terminate. When performance has been offered late or otherwise does not conform to the contract, the aggrieved party will lose its right to terminate the contract unless it gives notice to the other party within a reasonable time after it has or ought to have become aware of the offer or of the non-conforming performance. The Official Comments discuss two situations where time limits for late performance under Article 7.3.2(2) are not directly applicable, but the good faith principle may require the aggrieved party to inform the non-performing party whether it intends to accept the late performance.²⁵¹² First situation occurs when the non-performing party asks the aggrieved party whether it will accept late performance. Second situation is the case where the aggrieved party learns from another source that the non-performing party intends to perform. In these situations, if the aggrieved party fails to inform the other party if it does not wish to accept the late performance, it may be held liable in damages. However, where the non-performing

²⁵⁰⁹ Official Comment 1 to Article 7.1.4 of the UNIDROIT Principles

²⁵¹⁰ Official Comment 8 to Article 7.1.4 of the UNIDROIT Principles

²⁵¹¹ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 751

²⁵¹² Official Comment 2 to Article 7.3.2 of the UNIDROIT Principles

party asks the aggrieved party whether it intends to accept the late performance prior to the date of performance, the case will fall under Articles 7.3.3 and 7.3.4.²⁵¹³

Articles 7.3.3 and 7.3.4 of the UNIDROIT Principles govern the cases of anticipatory breach. Article 7.3.3 provides that where prior to the date for performance by one of the parties it is clear that there will be a fundamental non-performance by that party, the other party may terminate the contract. According to the Official Comment, it must be clear that there will be non-performance, and even a well-founded suspicion is not sufficient to invoke this provision. Moreover, it is required that the non-performance be fundamental and a notice of termination be given.²⁵¹⁴ When its conditions are satisfied, Article 7.3.3 allows the aggrieved party to terminate the contract before the time at which performance is due.²⁵¹⁵ The provision under Articles 7.3.3 is essentially based on Article 72 of the CISG. However, in contrast to Article 72 of the CISG, Article 7.3.3 of the UNIDROIT Principles does not require the aggrieved party to give notice of intention to terminate to the other party in order to allow him to provide adequate assurance of his performance. The lack of notification requirement is criticized on the ground that the notification requirement would reduce the possibility of an innocent party abusing its rights, promote communication and cooperation between the parties, and would maintain the balance between the two parties by offering the other party an opportunity to demonstrate its commitment and ability to perform the contract.²⁵¹⁶

Article 7.3.4 of the UNIDROIT Principles provides for the right to demand adequate assurance of due performance when a party reasonably believes that there will be a fundamental non-performance. Although Article 71 of the CISG and Article 7.3.4 of the UNIDROIT Principles contain different standards with regard to the required degree of probability of fundamental non-performance, there are similarities between the two provisions in the sense that both seem to establish a standard requiring a lower degree of probability than that of the standard of being “clear”.²⁵¹⁷ Article 7.3.4 enables a party demanding adequate assurance to withhold his own performance in the meantime and to terminate the contract if adequate assurance of due performance is not given within a reasonable time. This provision forms a separate ground for termination, which is independent of Articles 7.3.1 and 7.3.3.

Article 7.3.5 of the UNIDROIT Principles provides for the prospective effect of the termination for non-performance. The provision states that termination releases both parties from their future performance obligations, and that termination will neither preclude claims for damages nor affect those provisions in the contract for the settlement of disputes or any other term of the contract which is to operate even after termination. The Official Comment refers to clauses relating to dispute settlement, and other terms, which by their very nature are intended to operate even after termination, such as confidentiality agreements.²⁵¹⁸

²⁵¹³ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 843

²⁵¹⁴ Official Comment to Article 7.3.3 of the UNIDROIT Principles

²⁵¹⁵ Illustration in Official Comment to Article 7.3.3 of the UNIDROIT Principles

²⁵¹⁶ Saidov, Djakhongir, *Anticipatory Non-Performance and Underlying Values of the UNIDROIT Principles*, *Uniform Law Review* (2006), at 810-811

²⁵¹⁷ *Ibid.*, at 812-813

²⁵¹⁸ Official Comment 3 and Illustration 2 to Article 7.3.5 of the UNIDROIT Principles

The 2004 edition of the UNIDROIT Principles addressed the issue of restitution following the termination of the contract for non-performance in Article 7.3.6. It provided, in paragraph (1), that on termination of the contract either party may claim restitution of whatever it has supplied, provided that such party concurrently makes restitution of whatever it has received, and, in paragraph (2) that, if performance of the contract has extended over a period of time and the contract is divisible, restitution can only be claimed for the period after termination has taken effect. Article 7.3.6 (1) also provided that if restitution in kind is not possible or appropriate, allowance should be made in money whenever reasonable. However, the approach of Article 7.3.6 was considered unsatisfactory. It is criticized as being vague, since it did not expressly take account of the causes of the impossibility of restitution in kind and the obligor's responsibility for destruction of or injury to the goods.²⁵¹⁹ Moreover, it left unsettled a number of questions whether the recipient of performance is entitled to compensation for expenses incurred for the preservation or maintenance of the object of the performance, and whether the recipient must make restitution of any benefits it may have received from the performance.²⁵²⁰ It is also argued that the rules on restitution in case of termination should not adopt sales contracts as the paradigm model.²⁵²¹

As a result of the discussions of the Working Group assigned with the task of preparing a third edition of the UNIDROIT Principles, the new Articles 7.3.6 and 7.3.7 of the UNIDROIT Principles 2010 take those considerations into account. The new Articles make a clearer distinction between different types of contracts with regard to the issues of restitution after termination of the contract for non-performance. Article 7.3.6 deals only with "contracts to be performed at one time", while "contracts to be performed over a period of time" are covered by Article 7.3.7. The Official Comments to Article 7.3.6 state that the most common example of a contract to be performed at one time is an ordinary contract of sale where the entire object of the sale has to be transferred at one particular moment. According to the Official Comments, a turnkey contract, in which the contractor is under an obligation to produce the entire work to be accepted by the customer at one particular time, is also considered as a contract to be performed at one time.²⁵²² The distinction is based on the concept of characteristic performance under private international law, in order to distinguish better between contracts to be performed at one time and contracts to be performed over a period of time.²⁵²³ The Official Comments explain that under a commercial contract one party will usually have to pay money for the performance received, and that obligation is not the one

²⁵¹⁹ Schlechtriem, Peter, Termination of Contracts under the Principles of International Commercial Contracts, in Michael Joachim Bonell & Franco Bonelli (eds.), *Contratti commerciali internazionali e Principi UNIDROIT*, Giuffr , Milano 1997, at 268; This issue was particularly emphasized by the Rapporteur, Professor Reinhard Zimmermann. UNIDROIT 2007 - Study L - Doc. 100, Hamburg - April 2007, at para. 17

²⁵²⁰ The first position paper prepared by the Rapporteur, Professor Reinhard Zimmermann suggested that the new rules should provide that compensation may be claimed for the necessary expenses incurred on the object received, and compensation for other expenses incurred on the object may be claimed as far as the other party is enriched by them. As to the issue of benefits, he suggested that compensation for value has to be paid for the benefits that a party has failed to derive from the performance in accordance with ordinary business practice, provided the party knew or ought to have known of the ground for avoidance or termination. UNIDROIT 2007 - Study L - Doc. 100, Hamburg - April 2007

²⁵²¹ Zimmerman, Reinhard, The Unwinding of Failed Contracts in the UNIDROIT Principles 2010, *Uniform Law Review*, (2011), at 568; UNIDROIT 2006 - Study L - Misc. 26, October 2006, at para. 48; UNIDROIT 2007 - Study L - Misc.27, November 2007, at paras. 240, 322; UNIDROIT 2008 - Study L - Misc.28, October 2008, at paras. 21, 27

²⁵²² Official Comment 1 to Article 7.3.6 of the UNIDROIT Principles

²⁵²³ UNIDROIT 2009 - Study L - Misc. 29, October 2009, at para. 4

that is characteristic of the contract. Thus, a contract of sale where the purchase price has to be paid in instalments, will fall under Article 7.3.6 provided that the seller's performance is to be made at one time.²⁵²⁴ On the other hand, a contract of sale where the goods have to be delivered in instalments will be considered as a contract to be performed over a period of time, and Article 7.3.7 will be applied.²⁵²⁵

Article 7.3.6 (1) grants each party a right to claim the return of whatever the party has supplied under the contract provided that that party concurrently makes restitution of whatever it has received. Article 7.3.6 (2), which corresponds to the former rule, provides that if restitution in kind is not possible or appropriate, an allowance has to be made in money whenever reasonable. The Official Comments state that the allowance will normally amount to the value of the performance received. Article 7.3.6 (2) refrain from specifying the condition of appropriate allowance, in order to provide the decision maker with the sufficient flexibility with regard to the choice between objective and subjective value of the performance.²⁵²⁶ As to the standard of appropriateness of restitution in kind, the Official Comments refer to Article 7.2.2(b), which excludes the claim for specific performance, if it is unreasonably burdensome or expensive.²⁵²⁷ The Official Comments state that the purpose of specifying that allowance should be made in money "whenever reasonable" is to make it clear that allowance should only be made if, and to the extent that, the performance received has conferred a benefit on the party claiming restitution.²⁵²⁸

Article 7.3.6 (3) provides that the recipient of the performance does not have to make an allowance in money if the impossibility to make restitution in kind is attributable to the other party. According to the Official Comments, this provision implies an allocation of risk.²⁵²⁹

²⁵²⁴ Official Comment 1 to Article 7.3.6 of the UNIDROIT Principles

²⁵²⁵ Zimmerman, Reinhard, *The Unwinding of Failed Contracts in the UNIDROIT Principles 2010*, Uniform Law Review, (2011), at 585

²⁵²⁶ During the discussions of the Working Group, the term "allowance" was criticized for being vague and the Rapporteur Zimmermann suggested the term "compensation for value". UNIDROIT 2007 - Study L - Misc.27, November 2007, at para. 296; However, The majority of the Working Group was in favor of keeping "allowance" because it was widely used, e.g. in the United States, and it was sufficiently flexible so as to cover the concepts of both objective value and subjective value. UNIDROIT 2008 - Study L - Misc.28, October 2008, at para. 22

²⁵²⁷ Official Comment 3 to Article 7.3.6 of the UNIDROIT Principles

²⁵²⁸ Official Comment 2 to Article 7.3.6 of the UNIDROIT Principles; during the discussions of the Working group, the notion of "whenever reasonable" had been questioned as being too vague, but the majority wanted a sufficiently flexible rule to cover all kinds of contingencies that might come up and therefore the decision was taken to keep "whenever reasonable". UNIDROIT 2008 - Study L - Misc.28, October 2008, at para. 22

²⁵²⁹ The Rapporteur Zimmermann focused on the question of what happens if one of the parties is unable to return the performance received by him because what he has received has deteriorated or has been destroyed. In his opinion, the problem was one of risk allocation. He proposed to draft a rule that places the risk of accidental deterioration and destruction on the recipient of the performance. He criticized the risk regime of Article 82 of the CISG and suggested that it should not be regarded as a model on which the UNIDROIT regime can be based. He gave the following reasons for his position: "According to Art. 82 CISG, the purchaser loses the right to terminate the contract if it is impossible for him to make restitution of the goods substantially in the condition in which he received them (Art. 82 (1)). That does not, however, apply if the impossibility of making restitution is not due to his act or omission (Art. 82 (2)(b)). These rather involved provisions place the risk of accidental destruction at least very largely, and contrary to first appearances, on the seller, for if the purchaser retains the right to terminate, provided the impossibility to return is not due to his act or omission, he may claim back his purchase price even though he is unable to return the object received. But when is the impossibility to return due to the purchaser's "act or omission"? This is a very vague criterion rendering the risk rule's scope of application quite uncertain. What appears to be the general rule (Art. 82 (1)) turns out to be the exception after all (Art. 82

Under this allocation, the recipient of performance is liable to make good the value of that performance if it is unable to make restitution in kind. The provision applies even if the recipient was responsible for the deterioration or destruction of what it had received. The Official Comments state that such allocation of the risk of deterioration or destruction is justified, in particular, because the risk should lie with the person in control of the performance. In this regard, Article 7.3.6 (3) solely makes it explicit that there is no liability to make good the value where the deterioration or destruction is attributable to the other party: either because it was due to the other party's fault, or because it was due to a defect inherent in the performance. According to the Official Comments, the recipient's liability to make good the value of the performance received is not excluded in cases where the deterioration or destruction would also have occurred had the performance not been rendered. The Official Comments explain that the question of the recipient's liability to pay the value of the performance only arises in cases where the deterioration or destruction occurs before termination of the contract, but if what has been performed deteriorates or is destroyed after termination of the contract, the normal rules on non-performance apply, and gives the other party a right to claim damages according to Article 7.4.1, unless the non-performance is excused under Article 7.1.7.²⁵³⁰ Finally, Article 7.3.6 (4) allows the recipient of performance to claim compensation for expenses reasonably required to preserve or maintain the performance received.

Article 7.3.6 does not take a position concerning the benefits that have been derived from the performance, or interest that has been earned. During the discussions of the Working Group, there was insufficient support for the proposed rule on the benefits.²⁵³¹ There were various reasons put forward by the members of the Working Group, including such arguments that the cases envisaged by the rule were not considered by some members as important so as to justify having such a rule in the Principles²⁵³²; that it is already stated that if a party does not pay a sum of money when it falls due, the aggrieved party is entitled to interest under Article 7.4.9²⁵³³, and that a rule on benefits would engender litigation and would unduly complicate matters.²⁵³⁴ It is pointed out that even the term "benefit" is open to doubt and misunderstanding, at least on an international level, leading to such questions as whether compensation must be made for benefits that recipient has failed to derive from the

(2)(a)). And the general policy of saddling the seller with the risk is very questionable." He suggested that there should be a rule which requires compensation for value also has to be paid insofar as the object received has deteriorated or has been destroyed, but there should be an exception to this rule to cover cases where the object deteriorates, or is destroyed, as a result of the defect inherent in it. According to Zimmermann, even though the defectiveness of the object supplied, and hence of the deterioration or destruction resulting from that defectiveness, may not be due to the seller's fault, it is still true to say that the risk of deterioration or destruction emanates from his sphere. In other words, a seller, who creates the risk which has to be distributed, cannot reasonably complain if he finds himself burdened with it. Thus, he proposed a rule that exclude the duty to pay compensation for value in all cases where the deterioration or destruction was attributable to the other party (i.e. the creditor). UNIDROIT 2007 - Study L - Doc. 100, Hamburg - April 2007

²⁵³⁰ Official Comment 4 to Article 7.3.6 of the UNIDROIT Principles

²⁵³¹ UNIDROIT 2007 - Study L - Misc.27, October 2008, at para. 63-64

²⁵³² Ibid., at para. 355

²⁵³³ Ibid., at para. 370

²⁵³⁴ UNIDROIT 2008 - Study L - Doc. 105, April 2008, Appendix A, at 3

performance, and whether the benefits received should remain with the recipient if he was in good faith.²⁵³⁵

In particular, the Working Group's decision seemed to have been influenced by the observations from the international business practice. Professor Christine Chappuis, having consulted the Groupe de travail contrats internationaux²⁵³⁶, stated that practitioners seemed rather skeptical, in the sense that in their experience the question as to whether in case of restitution also the benefits received must be taken into account seldom occurred and, in practice, parties are normally satisfied to get back what they have delivered under the contract and, in the rare case that one party intends to claim in addition compensation for the benefits the other party has received from that performance, such a claim would be part of the claim for damages. This observation was also confirmed by the Rapporteur of the relevant rules, Professor Reinhard Zimmermann, who had also made some enquiries in the business world. He stated that the answers he had received were basically the same as those reported by Chappuis, i.e. that in case of termination parties wanted to get back their performance but did not care about additional benefits. In his view the reason was that in commercial practice normally both parties receive some benefits and it would be inconvenient to try to evaluate them with a view to their return. Finally Emmanuel Jolivet, observer for the ICC International Court of Arbitration, reported that, at the ICC, a brief enquiry had been made concerning awards mentioning restitution of benefits and over the last 10 years only 4 awards were found in which restitution of benefits had been claimed by one of the parties.²⁵³⁷ Thus, the Official Comments to Article 7.3.6 state that "In commercial practice it will often be difficult to establish the value of the benefits received by the parties as a result of the performance. Furthermore, often both parties will have received such benefits."²⁵³⁸

Article 7.3.7 (1) contains a special rule, which excludes restitution for performances made in the past, with respect to contracts to be performed over a period of time. It provides that, on termination of a contract to be performed over a period of time, restitution can only be claimed for the period after termination has taken effect, provided the contract is divisible. The Official Comments underline that "contracts to be performed over a period of time are at least as commercially important as contracts to be performed at one time." According to the Official Comments, contracts to be performed over a period of time include leases (e.g. equipment leases), contracts involving distributorship, out-sourcing, franchising, licensing and commercial agency, service contracts in general as well as contracts of sale where the goods have to be delivered in instalments. It is explained that performances under such contracts can have been made over a long period of time before the contract is terminated, and

²⁵³⁵ Zimmerman, Reinhard, *The Unwinding of Failed Contracts in the UNIDROIT Principles 2010*, Uniform Law Review, (2011), at 579-582

²⁵³⁶ Groupe de travail contrats internationaux is a working group established in 1975 by Marcel Fontaine. The Group conducts a systematic analysis of the main types of clauses appearing in international contracts. The Group uses large samples taken from the practical experience of its members, which consist of corporate lawyers, members of the Bar and professors specializing in international trade transactions. The Group meets usually two or three times a year. All studies have been published, either in *Droit et Pratique du Commerce International*, or in the *International Trade Journal*. From 1975 to 1992, the Group was chaired by Marcel Fontaine, before Filip De Ly took the chair. The updated versions of the different studies published between 1975 and 2001 were gathered and coordinated in a book: Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009

²⁵³⁷ UNIDROIT 2008 - Study L - Misc.28, October 2008, at para. 52-56

²⁵³⁸ Official Comment 6 to Article 7.3.6 of the UNIDROIT Principles

it may thus be inconvenient to unravel these performances.²⁵³⁹ In those cases, restitution can only be claimed in respect of the period after termination, provided that the contract is divisible. Article 7.3.7 (2) provides that as far as restitution has to be made, the provisions of Article 7.3.6 apply.

The 2010 edition of the UNIDROIT Principles clarifies some of the unresolved questions arising from the 2004 edition with regard to restitution after termination of the contracts, which could only be answered on the basis of its underlying general principles in accordance with Article 1.6 (2).²⁵⁴⁰ Above all, both the 2004 and 2010 editions of the UNIDROIT Principles allow restitution rather liberally, as they do not limit restitution to cases of a total failure of consideration or to cases where no counter-performance has been received, and nor do they exclude the right to terminate the contract for non-performance in cases of impossibility of restitution in kind. It is argued that, by so doing, the Principles take the middle ground between those legal systems which regard termination as retrospective and those legal systems which regard it as essentially prospective.²⁵⁴¹ Moreover, the Principles grant the decision maker the maximum flexibility with regard to such matters as determining the value of performance when the restitution in kind is not possible or appropriate.

The rules on termination of contract under the PECL are similar to those of UNIDROIT Principles. The approach of the UNIDROIT Principles that makes termination of contract possible in the event of a fundamental non-performance is also found in the PECL. Article 9:301 (1) provides that a party may terminate the contract if the other party's non-performance is fundamental. Under Article 8:103, a non-performance of an obligation is fundamental to the contract when (a) strict compliance with the obligation is of the essence of the contract, or (b) the non-performance substantially deprives the aggrieved party of what it was entitled to expect under the contract, unless the other party did not foresee and could not reasonably have foreseen that result, or (c) the non-performance is intentional and gives the aggrieved party reason to believe that it cannot rely on the other party's future performance. Article 8:103 of the PECL is not drafted as a mere list of factors to be taken into account, but describes three cases in which a breach is fundamental. The provision does not include the disproportionate loss factor as a countervailing circumstance against the characterization of fundamental non-performance, which is found in the UNIDROIT Principles.²⁵⁴² The provision also merges the intention factor with the loss of reliance factor into one element thereby making it clear that a minor breach committed intentionally and recklessly does not constitute a fundamental non-performance.²⁵⁴³

²⁵³⁹ Official Comment 1 to Article 7.3.7 of the UNIDROIT Principles

²⁵⁴⁰ For instance, under the 1994 edition of the UNIDROIT Principles, it was suggested that Article 7.3.6 providing for an appropriate allowance insofar as restitution in kind is not possible can be considered as a comprehensive rule for damages “in lieu of restitution” insofar as the damages concerned are meant to take the place of the restitutionary obligations. Thus, on the basis of the similarity of functions between the allowance in cases of restitution and the damages for non-performance, some unsolved questions could be answered by the analogous application of the rules of non-performance as contained in Chapter 7 of the Principles. Schlechtriem, Peter, Termination and Adjustment of Contracts [Under the UNIDROIT Principles of International Commercial Contracts], *European Journal of Law Reform*, 1-3 (1999), at 319-320

²⁵⁴¹ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 854

²⁵⁴² *Ibid.*, at 822-823

²⁵⁴³ Lando Ole, Termination for Breach of Contract in the CISG, the Principles of European contract law, the UNIDROIT Principles of international commercial contracts, in K. Boele-Woelki and F.W. Grosheide (eds), *The Future of European Contract Law, Liber Amicorum E.H. Hondius*, Kluwer International, 2007, at 200; Lando,

Article 8:106 of the PECL contains a *Nachfrist* mechanism, on the basis of two rules: (1) Even where the aggrieved party has an immediate right to terminate because of the other's non-performance, if the aggrieved party has indicated that it is still prepared to accept performance, it may not change its mind without warning since the other party may have relied on having the period set in the notice in which to perform; and (2) Where there has been a delay in performance but the delay is not fundamental, the aggrieved party may terminate the contract after having given the non-performing party reasonable notice.²⁵⁴⁴ Thus, when there has been a non-performance by one party, the aggrieved party may always fix an additional period of time for performance. However, during the period fixed the aggrieved party may not seek specific performance or terminate the contract, while it may withhold its own performance and it may claim damages for the delay in performance or other losses caused by the non-performance. Pursuant to Article 8:106 (3), in a case of delay in performance which is not fundamental, the aggrieved party may in its notice provide that if the other party does not perform within the period fixed by the notice the contract shall terminate automatically. If the period stated is too short, the aggrieved party may terminate, or the contract shall terminate automatically, only after a reasonable period from the time of the notice.

Article 8:104 of the PECL restricts the right to cure to those cases where the time for performance has not yet arrived, or where the delay would not be such as to constitute a fundamental non-performance. Thus, there is no right to cure if time is of the essence or has become of the essence following the expiry of a notice under Article 8:106.²⁵⁴⁵ However, this provision does not affect the general rule that, in all cases of non-fundamental non-performance, the non-performing party maintains a general right to cure. Moreover, Article 9:303 (3) (b) alleviates the strictness of the primacy of termination over cure, in the case of fundamental non-performance that may be cured without the delay. It provides that in cases in which the aggrieved party knows or has reason to know that the other party intends to tender within a reasonable time, it must notify the other party of its refusal to accept performance in order to maintain its right to terminate the contract. Thus, failure to notify the curing party accordingly will prevent the aggrieved party from termination the contract if the other party in fact tenders cure within a reasonable time.²⁵⁴⁶

Article 9:303 (1) provides that a party's right to terminate the contract is to be exercised by notice to the other party. According to the second paragraph, the aggrieved party loses its right to terminate the contract unless it gives notice within a reasonable time after it has or ought to have become aware of the non-performance. Article 9:303 (3) (a) provides that when a tender of performance is due but has not been made, the aggrieved party need not give notice of termination before a tender has been made. If a tender is later made it loses its right

Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 365-366

²⁵⁴⁴ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 372

²⁵⁴⁵ *Ibid.*, at 368

²⁵⁴⁶ Yovel, Jonathan, *Cure after date for delivery: Comparison between provisions of the CISG (seller's right to remedy failure to perform: Article 48) and the counterpart provisions of the Principles of European Contract Law (Articles 8:104 and 9:303)*, in John Felemegas (ed.), *An International Approach to the Interpretation of the United Nations Convention on Contracts for the International Sale of Goods (1980) as Uniform Sales Law*, Cambridge University Press, 2007, at 391

to terminate if it does not give such notice within a reasonable time after it has or ought to have become aware of the tender. Article 9:303(3) (c) provides an exception to the notice requirement in cases where one of the parties is permanently excused from non-performance under the force majeure rule.

Article 9:304 of the PECL deals with anticipatory non-performance and allows a party to terminate the contract, where prior to the time for performance by the other party it is clear that there will be a fundamental non-performance by it. In the Official Comment, it is stated that the need to notify the other party within a reasonable time does not apply to cases of anticipatory non-performance.²⁵⁴⁷ In order for this Article to apply it must be clear that a party is not willing or able to perform at the due date. If its behavior merely results in doubt as to its willingness or ability to perform, Article 8:105 entitles a party, who reasonably believes that there will be a fundamental non-performance by the other party, to demand adequate assurance of due performance and to withhold performance of its own obligations so long as such reasonable belief continues. Article 8:105 appears to go further than Article 7.3.4 of the UNIDORIT Principles by explicitly providing that the aggrieved party may withhold its own performance “as long as such reasonable belief continues”. It is argued that this does not result in substantial differences between the two provisions as the usual way of overcoming such a belief is to provide adequate assurances of performance.²⁵⁴⁸ Where this assurance is not provided within a reasonable time, the party demanding it may terminate the contract if it still reasonably believes that there will be a fundamental non-performance by the other party, and gives notice of termination.

Article 9:305 provides that the termination of contract releases both parties from their obligation to effect and to receive future performance, but, subject to Articles 9:306 to 9:308, does not affect the rights and liabilities that have accrued up to the time of termination. The drafters of the PECL considered it “inconvenient” to treat a contract that has been terminated as being cancelled in the sense of never having been made.²⁵⁴⁹ Thus, in principle, any contractual performance already received does not need to be returned, nor is it necessary to make restitution of its value. Article 9:305 states that termination is not retroactive and specifically mentions the contractual clauses surviving termination. Under Article 9:305 (2), termination does not affect any provision of the contract for the settlement of disputes or any other provision which is to operate even after termination. Moreover, termination does not preclude a claim for damages for non-performance.²⁵⁵⁰

Even though termination is prospective in general, there are situations where the PECL accords retrospective effect to termination. Article 9:306 provides that the aggrieved party may reject a performance already received if its value to it has been fundamentally reduced as a result of the other party's non-performance. The PECL also allows for a restitutionary remedy after termination, where one party has conferred a benefit on the other party but has not received the promised counter-performance in exchange. The benefit may consist of

²⁵⁴⁷ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 414

²⁵⁴⁸ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 852

²⁵⁴⁹ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 419

²⁵⁵⁰ Article 8:102 of the PECL provides that a party is not deprived of its right to damages by exercising its right to any other remedy.

money paid (Article 9:307), other property which can be returned (Article 9:308) or some benefit which cannot be returned, e.g. services or property which has been used up (Article 9:309).²⁵⁵¹ On termination of the contract, Article 9:307 provides that a party may recover money paid for a performance which it did not receive or which it properly rejected. A party, who returns money paid, will have to pay interest on the money for the period that it has in possession in accordance with Article 9:508.²⁵⁵² Pursuant to Article 9:308, a party who has supplied property which can be returned and for which it has not received payment or other counter-performance may recover the property. Under Article 7:110 (4), when the contract has been terminated and the property must be returned by the recipient to the other party, if the other party fails to accept or retake the property, the recipient must take reasonable steps to protect and preserve the property and it is entitled to be reimbursed or to retain out of the proceeds of sale any expenses reasonably incurred. Article 9:309 provides that a party, who has rendered a performance which cannot be returned and for which it has not received payment or other counter-performance, may recover a reasonable amount for the value of the performance to the other party. As to the calculation of this amount, the Official Comments state that the party which has received the benefit should not be required to pay the cost to the other of having provided it, if the net benefit to it is less, since it is only enriched by the latter amount, and if the net benefit to the recipient is greater than the cost of providing it, the recipient should not be liable under this article for more than an appropriate part of the contract.²⁵⁵³

Thus, similar to UNIDROIT Principles, under the PECL, the aggrieved party is allowed to terminate even if he cannot restore the performance in kind substantially in the condition in which he received them, but he must account to the other party for the benefits he has derived from the performance.²⁵⁵⁴ However, the approach of the PECL, which is considered akin to the position under English law, was criticized for its unnecessarily complex differentiation between different types of performance, and for its focus on the lack of counter-performance, which reveals that these provisions were modeled on the English concept of total failure of consideration that has increasingly been criticized in its country of origin.²⁵⁵⁵ Moreover, the PECL do not cover such issue as benefits derived from performance in the context of restitution of the property, and how the deterioration or destruction of the performance rendered affects the unwinding of the contract.²⁵⁵⁶

c. Contracting Practices

In international contracting practices, termination clauses are much more tailor-made than typical boilerplate clauses, because termination clauses relate to the core of the contract.

²⁵⁵¹ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 422

²⁵⁵² *Ibid.*, at 421

²⁵⁵³ *Ibid.*, at 425-426

²⁵⁵⁴ Lando Ole, *Termination for Breach of Contract in the CISG*, the *Principles of European contract law*, the UNIDROIT *Principles of international commercial contracts*, in K. Boele-Woelki and F.W. Grosheide (eds), *The Future of European Contract Law*, Liber Amicorum E.H. Hondius, Kluwer International, 2007, at 209

²⁵⁵⁵ Zimmermann, Reinhard, *Restitutio in Integrum: The Unwinding of Failed Contracts under the Principles of European Contract Law*, the UNIDROIT *Principles and the Avant-projet d'un Code Europeen des Contrats*, *Uniform Law Review*, (2005), at 723-724

²⁵⁵⁶ *Ibid.*, at 725, 729

Termination clauses are an important subject of negotiations between parties. The bargaining power and negotiation strategies greatly affect the contents of the termination clauses. An imbalance to which a party agrees regarding one part of the termination clause is sometimes set off by modification to another part of the termination clause.²⁵⁵⁷ Moreover, as the national legal systems, to a great extent, do not impose mandatory rules regarding termination of the contracts, the contracting parties themselves usually clarify or modify termination aspects of their contractual relationship in accordance with their specific contractual setting.²⁵⁵⁸ Particularly, termination clauses give rise to a category of cases, in which the requirement of seriousness of non-performance under national laws need not be satisfied.²⁵⁵⁹ The international contract practice has developed the technique of express termination clauses in order to minimize the court intervention, which may slow down the process of termination and introduce uncertainty and unpredictability as to whether termination will ensue.²⁵⁶⁰ For these reasons, there is a great variety of termination clauses that can be found in international contracts.

It is also possible to observe a tendency of international contracting practices towards a common abstract understanding of the issues relevant to termination clauses. These clauses usually do not limit the right to terminate the contract to cases involving a breach of contract. In particular, in case of long-term contracts, termination clauses provide that various circumstances, which affect the relationship between the parties, may justify the termination of the contract. Thus, the parties explicitly provide for the termination of the contract in certain circumstances, under which the parties no longer wish to continue their contractual relationships. In light of these considerations, it can be observed that there is a growing tendency in contracts with parties having similar bargaining power to approach the issue of termination not from the question of who is to blame for termination, but rather when and how termination is to be achieved, whereby the termination becomes an inherent stage in the contractual relationship and an issue of risk allocation between the parties. This approach is most visible in the deadlock and divorce clauses in international joint venture contracts.²⁵⁶¹ It is also relevant to any other forms of transactions governed through legal uncertainty, which typically require longer term relationship and involve great interests on both sides. Moreover, where it is important to find ways out which are acceptable for both parties, the contracting parties are more inclined to draft the contract in terms of problem solution through the incorporation into the termination clauses such mechanisms as Nachfrist and cure by the non-performing party.²⁵⁶²

Termination clauses in international contracting practices cover a wide range of different situations, which lead to the termination of contracts. These include the effect of a condition

²⁵⁵⁷ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 566

²⁵⁵⁸ *Ibid.*, at 570

²⁵⁵⁹ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 134

²⁵⁶⁰ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 578

²⁵⁶¹ De Ly Filip, *Divorce Clauses in International Joint Venture Contracts*, International Business Law Journal, (1995), at 291-294

²⁵⁶² Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 572

subsequent, an agreement by the contracting parties to terminate the contract, the breach of certain contractual obligations, the passing of a period for which the contract has been concluded in case of fixed term contracts, notice given by one party to the other party in case of contracts concluded for an indefinite period, and such circumstances as a party's involvement in insolvency, bankruptcy or similar proceedings or even in bribery.²⁵⁶³ In line with the trend of contracting parties to draft termination clauses in terms of problem solution and risk allocation, termination clauses provide a mixture of various termination grounds and procedures as to the steps towards termination.

This is particularly apparent in the FIDIC Conditions. The FIDIC Conditions for major works provide in Clause 15 the terms regarding "Termination by the Employer" and in Clause 16 those dealing with "Suspension and Termination by Contractor". These clauses set out the various grounds which will entitle the Employer to terminate the contract or entitle the Contractor to suspend or terminate the contract. First of all, Sub-Clause 15.1 provides that if the Contractor fails to carry out any obligation under the Contract, the Engineer may by notice require the Contractor to make good the failure and to remedy it within a specified reasonable time. In such a case, the Employer may terminate the contract when the Contractor fails to comply with the notice to correct. This provision introduces a *Nachfrist* mechanism, which assures that a mere breach does not suffice to trigger the application of the termination clause, and provides the Contractor with an opportunity to cure his defective performance.

Sub-Clause 15.2 allows the Employer to terminate the contract for specified defaults by the Contractor. The Employer is entitled to terminate the contract if the Contractor fails to comply with Sub-Clause 4.2 (Performance Security) or with a notice under Sub-Clause 15.1, or fails, without reasonable excuse, to proceed with the Works in accordance with Clause 8 (Commencement, Delays and Suspension) or to comply with a notice issued under Sub-Clause 7.5 (Rejection) or Sub-Clause 7.6 (Remedial Work), within 28 days after receiving it, or subcontracts the whole of the Works or assigns the Contract without the required agreement. Sub-Clause 15.2 also contains a provision regarding anticipatory breach of the Contract, which allows the Employer to terminate the contract if the Contractor abandons the Works, or "otherwise plainly demonstrates the intention not to continue performance". In all those cases, the Employer may, upon giving 14 days' notice to the Contractor, terminate the Contract and expel the Contractor from the Site. Sub-Clause 15.2 explicitly reserves the Employer's claim for damages in the case of his termination of the contract by providing that the Employer's election to terminate the Contract shall not prejudice any other rights of the Employer's under the Contract or otherwise. Sub-Clause 15.2 also enables the Employer to terminate the contract by notice immediately, when the Contractor becomes insolvent or bankrupt, or commits bribery. The ground of bribery for immediate termination responds to the current emphasis on the subject of bribery among international development banks.²⁵⁶⁴ This ground can also be found in the general practice of drafting termination clauses under construction contracts.²⁵⁶⁵ In the Multilateral Development Bank Harmonized Edition of the FIDIC Conditions, Sub-Clause 15.6 explicitly provides that "If the Employer determines that the Contractor has engaged in corrupt, fraudulent, collusive or coercive practices, in

²⁵⁶³ Ibid., at 569

²⁵⁶⁴ Jaynes, Gordon L., Termination, Risk and Force Majeure, Paper presented at the Seminar "FIDIC Global Conditions of Contract", New Delhi, January 2001, available at http://www1.fidic.org/resources/contracts/jaynes_A.asp

²⁵⁶⁵ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 575

competing for or in executing the Contract, then the Employer may, after giving 14 days notice to the Contractor, terminate the Contractor's employment under the Contract and expel him from the Site, and the provisions of Clause 15 shall apply as if such expulsion had been made under Sub-Clause 15.2."

Sub-Clause 15.5 of the 1999 Edition introduces the right of the Employer to terminate for convenience, which was absent from the previous editions.²⁵⁶⁶ It provides that the Employer may terminate the Contract, at any time for the Employer's convenience, by giving notice of such termination to the Contractor. The termination shall take effect 28 days after the later of the dates on which the Contractor receives this notice or the Employer returns the Performance Security. In order to ensure that this clause is not abused by the Employer, Sub-Clause 15.5 provides that the Employer shall not terminate the Contract under this Sub-Clause in order to execute the Works himself or to arrange for the Works to be executed by another contractor or to avoid a termination of the Contract by the Contractor. In the case of a termination for convenience, the Contractor is only entitled to be paid for work done and is not entitled to his profit on the balance of the contract which he is being deprived of the right to complete.

The FIDIC Conditions enable the Contractor either to suspend work or to terminate the contract under certain circumstances. Sub-Clause 16.1 allows the Contractor to suspend work if he is not being paid amounts to which he is entitled in due time. He may also suspend work, where the Engineer fails to certify a payment certificate when he should do so, and where the Employer fails to provide reasonable evidence that financial arrangements have been made and are being maintained to enable the Employer to pay the Contract Price in accordance with the contract payment schedule. Sub-Clause 16.2 entitles the Contractor to terminate the contract if the Contractor does not receive the reasonable evidence of the Employer's financial arrangements within 42 days after giving notice to suspend work. The Contractor may also terminate the contract if the Engineer fails, within 56 days after receiving a payment application and supporting documents, to issue the relevant Payment Certificate. The FIDIC Conditions was criticized in the past for not acknowledging the situation where the Engineer himself fails to perform his duty and, this provision aims at granting the Contractor a remedy in this situation.²⁵⁶⁷ Sub-Clause 16.2 (d) provides a standard of fundamental non-performance for the Contractor's ability to terminate the contract: the Contractor may terminate the contract if the Employer substantially fails to perform his obligations under the Contract in such manner as to materially and adversely affect the ability of the Contractor to perform the Contract. Similar to the Employer's right to terminate, Sub-Clause 16.2 allows termination by the Contractor in cases of Employer's insolvency or bankruptcy, and assignment of contract without prior agreement of the Contractor. In any of these events or circumstances, the Contractor may, upon giving 14 days' notice to the Employer, terminate the Contract. However, the Contractor may by notice terminate the Contract immediately in the case of Employer's bankruptcy and prolonged suspension of work by the Engineer. It is also provided that termination by the Contractor will not prejudice any other rights of the Contractor, under the Contract or otherwise.

Sub-Clauses 15.2, 15.3, 15.4, 16.3 and 16.4 deals with the consequences of termination and provides for its prospective effect and restitutionary duties as well as detailed termination

²⁵⁶⁶ Seppälä, Christopher R., FIDIC's New Standard Forms of Contract – Risks, Force Majeure, Claims and Termination, *International Business Law Journal*, (2000), at 1023

²⁵⁶⁷ *Ibid.*, at 1025

procedures. Sub-Clause 15.2 provides that when the Employer terminates the contract, the Contractor must deliver to the Engineer any “required Goods, all Contractor's Documents, and other design documents made by or for him”. Reflecting the importance of cooperation during termination, Sub-Clause 15.2 provides that the Contractor shall use his best efforts to comply immediately with any reasonable instructions included in the notice of termination for the assignment of any subcontract, and for the protection of life or property or for the safety of the Works. It is provided that after termination, the Employer may complete the Works and use any Goods, Contractor’s Documents and other design documents made by or on behalf of the Contractor.

Sub-Clause 15.3 deals with the valuation of the work done by the Contractor after a notice of termination by Employer has taken effect, and requires the Engineer to agree or determine the value of the Works, Goods and Contractor’s Documents, and any other sums due to the Contractor for work executed in accordance with the Contract. Sub-Clause 15.4 sets out the terms of payment after termination by the Employer. It provides that Employer may (i) proceed with claims for any payment to which he considers himself to be entitled, (ii) withhold further payments to the Contractor until the costs of execution, completion and remedying of any defects, damages for delay in completion and all other costs incurred by the Employer, have been established, and/or (iii) recover from the Contractor any losses and damages incurred by the Employer and any extra costs of completing the Works.

Sub-Clause 16.3 provides that after a notice of termination under Sub-Clause 15.5 (Employer’s termination for convenience), Sub-Clause 16.2 (Termination by contractor) or Sub-Clause 19.6 (Optional termination, payment and release in cases of force majeure) has taken effect, the Contractor shall promptly cease all further work, except for such work as may have been instructed by the Engineer for the protection of life or property or for the safety of the Works, hand over Contractor’s Documents, Plant, Materials and other work, for which the Contractor has received payment, and remove all other Goods from the Site, except as necessary for safety, and leave the Site. When the Contractor terminates the contract in accordance with Sub-Clause 16.2, the Employer shall promptly return the Performance Security to the Contractor, pay the Contractor in accordance with Sub-Clause 19.6, which provides that that upon termination, the Engineer shall determine the value of the work done and issue a Payment Certificate, including amounts payable for works and certain costs incurred by the Contractor, and pay to the Contractor the amount of any loss or damage sustained by the Contractor as a result of the termination.

The general approach of the FIDIC Conditions to the issue of termination can also be found in the ICC model contract for the turnkey supply of an industrial plant. Article 30.1 allows the Purchaser to terminate the contract in cases where cumulated liquidated damages for delay exceeds the maximum amount determined by the parties or, where the Plant fails to attain minimum performance levels at the time of taking over. Article 30.2 allows the Supplier to terminate the contract if the Purchaser is in breach of any of its payment obligations and this breach continues longer than ninety days, or such other period as the parties may agree. Article 30 also provides a standard of fundamental non-performance requirement as well as an opportunity to cure for termination. Under Articles 30.1 (c) and 30.2 (a), either party may terminate the contract where the other party has failed to perform a substantial obligation under the contract after having been served “a notice of failure and make good” by the first party within a reasonable period. Moreover, Article 30 enables termination of the contract for insolvency as an instance of anticipatory breach. Either party may terminate the contract if the other party becomes bankrupt or insolvent and fails to provide, at the first party’s request, an

adequate security for the fulfillment of obligations. Finally, Article 30.1 (e) enables the Purchaser to terminate the contract if the Supplier is involved in bribery.

The introductory note to the ICC Model Contract for the turnkey supply of an industrial plant draws attention to the harsh consequences of the retrospective effect of termination, namely unreasonably high losses for the supplier resulting from returning the contract price and dismantling of the plant, which is frequently tailor made and cannot be resold. On the other hand, it is acknowledged that there is a need to protect the purchaser against the risk of being forced to keep a plant that does not fulfill its reasonable expectations.²⁵⁶⁸ Thus, Article 30 aims to achieve a balance between these conflicting considerations through a risk allocation. As to the effect of termination, Article 30.4 states that termination shall not affect obligations which have already been performed at the time when the termination notice is given nor the right to receive payment for obligations already performed.²⁵⁶⁹ This prospective effect does not apply in the case of termination by the Purchaser for the Plant's failure to attain minimum performance levels at the time of taking over. In such a case, the Purchaser may require the Supplier at its own cost to dismantle and remove the equipment from the site and to pay back the contract price, as far as received, to the Purchaser.

International finance agreements and share purchase agreements usually contain their own peculiar approach to the formulation of termination clauses. These clauses are usually specific to the representation and warranties part of the contract, where at least one of the parties states that certain events of default or other events enumerated in the termination clause do not exist at the time of the formation or performance of the contract.²⁵⁷⁰ Particularly, in the share purchase agreements, since the subject of the contract is the transfer of an enterprise, the sellers are required to cooperate for the achievement of the contractual purpose by conducting the business of the target enterprise in the ordinary course. Thus, those agreements usually contain measures against the behaviors of the sellers, which may decrease the value of the transaction to the buyer before the transfer actually occurs. Moreover, the share purchase agreements commonly include a form of risk allocation whereby the seller undertakes the risk of some objective events that affects the value of the target company, given that the target remains under the control of the seller during the period of time from the date of execution of the agreement until closing. Thus, the share purchase agreements regularly provide the buyers with an option to escape a deal when there is a material adverse change in the business operations, properties, prospects, assets or condition of the enterprise. These circumstances are determined more or less in detail in advance under the clauses, which are called "material adverse change" or "material adverse effect" clauses in practice. The share purchase agreements normally provide material adverse change protections for the buyer, but they are sometimes drafted to permit either party to terminate the transaction if a material adverse change has occurred with respect to the other party or if objective events that would constitute such a material adverse change have occurred.

The conditions of material adverse change are usually clearly defined by the parties in the contract, which provides quantitative guidelines as to what constitutes a material adverse

²⁵⁶⁸ ICC Model Contract for the Turnkey Supply of an Industrial Plant, ICC publication, 653, Paris, 2003, at 14

²⁵⁶⁹ Moreover, Article 34.5 explicitly provides that the confidentiality obligations shall survive any termination or expiration of the contract.

²⁵⁷⁰ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 573

change.²⁵⁷¹ However, adverse changes could conceivably be measured by means of a number of different quantitative indicia, and such clauses can significantly complicate the negotiation process.²⁵⁷² Thus, sometimes the parties only agree on a vague standard in defining the material adverse change, and such clauses require interpretation by the courts or arbitral tribunals particularly with regard to matters over which a party has only partial control, such as market share, or no control, such as the availability or price of one or more commodities. In such cases, the decision maker should take into consideration the overall context of the negotiation and the long-term strategic aspects of the businesses involved in interpreting the scope of broad material adverse change clause in order to ascertain the risk allocation between the parties, and require the buyer, who invokes a material adverse change exception to its obligation to close, to prove that the circumstances indeed warrant the required materiality of effect under that risk allocation, in order to prevent a buyer from utilizing opportunistically the breadth and vagueness of the clause for escaping a deal.²⁵⁷³

The ICC Model Mergers & Acquisitions Contract, Share Purchase Agreement, contains a material adverse change clause due to their increased frequency in practice.²⁵⁷⁴ However, the Model Contract does not provide any detail as to the definition of material adverse change, and merely advises the contracting parties wishing to utilize the model contract to give

²⁵⁷¹ An example provides that “ “Material Adverse Change” means with reference to a specific date one or several changes (or any event, fact, circumstance or development that is reasonably likely to result in any such changes) after such date that are adverse to the financial condition, assets, liabilities, results of operations, trading position or prospects of the Company with an adverse economic effect exceeding one million United States Dollars (\$1,000,000) (or the equivalent thereof)”, Share Purchase Agreement dated 12 June 2006, on file with the author

²⁵⁷² Adams, Kenneth A., A Legal-usage Analysis of “Material Adverse Change” Provisions, *Fordham Journal of Corporate & Financial Law*, 10 (2004), at 28-29

²⁵⁷³ For instance, *IBP Inc. v. Tyson Foods, Inc.* 789 A.2d 14; 2001 Del. Ch. LEXIS 81 (June 15, 2001). In the case, on January 1, 2001, Tyson and IBP entered into a contract whereby the former would acquire the latter. Under the contract, a material adverse effect is defined as “any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as whole” Tyson asserted that IBP had suffered a material adverse effect resulting from IBP’s poor financial performance in first quarter 2001, where its earnings were 64 percent behind those for the first quarter of 2000, and asset impairment charges arising from improper accounting practices at one of IBP’s subsidiaries. Tyson argued that it was permitted to terminate because IBP had breached a representation and warranty that IBP had not suffered a material adverse effect. The Delaware Chancery Court stated that “Material Adverse Effect” must be interpreted “in the larger context in which the parties were transacting.” The court observed that the definition of material adverse effect did not “preclude industry wide or general factors from constituting a Material Adverse Effect” and, if the target, IBP, had wanted to exclude these factors, “IBP should have bargained for it.” However, the court held that a general economic or industry downturn could not itself constitute a material adverse change and that Tyson had the burden of proving that such a general decline “had the required materiality of effect” on IBP itself. The court stated that “Merger contracts are heavily negotiated and cover a large number of specific risks explicitly. As a result, even where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror.” The court, by adopting a contextual approach and taking into account the reasonable expectations of the parties, considered that while the failure of a company to meet analysts’ projected earnings for a quarter could be highly material to a short-term speculator, such a failure would be less important to an acquiror who seeks to purchase the company as part of a long-term strategy. Thus, the court concluded that a Material Adverse Effect had not occurred and the contract could not be terminated on that ground. 789 A.2d, at 66-68

²⁵⁷⁴ Article 5 of the ICC Model Mergers & Acquisitions Contract 1 - Share Purchase Agreement, ICC Commission on Commercial Law & Practice, ICC Publication No. 656, 2004 Edition

particular regard not only to the specificities of the transaction and business but also to the evolution of practice and judge-made law in the relevant jurisdiction.²⁵⁷⁵ Article 5.3 of the Model Contract states that, in the event of a material adverse change, the buyer shall be excused from his obligations under the agreement without prejudice to available remedies when material adverse change being the result of an action or omission on the part of the seller. As Article 5.3 discharges the buyer from his obligation to pay, while reserving his claims for damages, its application results in automatic termination of the contract, in contrast to Article 6.1, which allows either party to terminate the contract with written notice with immediate effect when the conditions to closing have not satisfied by the closing date.

International practice of drafting termination clauses in terms of problem solution and risk allocation may be observed in the ICC Model Commercial Agency Contract. Article 18 of the Model Contract provides for the regular termination of the contract by giving a written notice, which effectively terminates the contract after a certain period of time. Apart from the regular termination, Article 20 allows the parties to terminate the contract with immediate effect in certain circumstances and applies irrespective of the contract's term being definite or indefinite. Article 20.1 provides that each party may terminate the contract with immediate effect by giving notice, in the event of a substantial breach by the other party, or in case of exceptional circumstances justifying termination. A substantial breach is defined by Article 20.2 as any failure by a party to carry out all or part of his obligations under the contract resulting in such detriment to the other party as to substantially deprive him of what is entitled to expect under the contract. This definition is clearly modeled on Article 25 of the CISG.²⁵⁷⁶ Article 20.3 enables the parties to list certain articles of the contract, violation of which justifies termination irrespective of the gravity of the breach. Moreover, Article 20.3 makes it clear that any violation of the contractual obligations may be considered as a substantial breach if such violation is repeated.

Article 20.2 of the Model Contract defines the exceptional circumstances, referred to under Article 20.1, as being circumstances in which it would be unreasonable to require the terminating party to continue to be bound by the contract. Article 20.4 lists certain exceptional circumstances, such as bankruptcy and other financial difficulties and any circumstance which are likely to affect substantially one party's ability to carry out his obligations. Moreover, the Model Contract provides Annex VII, which may be completed by the parties optionally. Annex VII allows the principal to terminate the contract immediately in the event of a change of control, ownership and/or management of the agent company. The omission to complete Annex VII or to mention a particular circumstance does not mean that this circumstance would never be considered an exceptional circumstance.²⁵⁷⁷

Article 20.6 regulates the consequences of unjustified early termination. If a party's termination of the contract is not justified, the termination will be effective, but the other party will be entitled to damages for the unjustified early termination. Such damages will be the loss suffered by the aggrieved party and the profit of which he has been deprived. In the absence of evidence of a greater or smaller loss, the damages will be equal to the average

²⁵⁷⁵ ICC Model Mergers & Acquisitions Contract 1 - Share Purchase Agreement, ICC Commission on Commercial Law & Practice, ICC Publication No. 656, 2004 Edition, at 27 fn. 5

²⁵⁷⁶ Lando, Ole, Article 20, in Bortolotti, Fabio, (ed.), The ICC Agency Model Contract, A Commentary, ICC Publication No. 512, Paris, 1993, at 78

²⁵⁷⁷ Ibid., at 79

commission for the period the contract would have been in force in case of a regular termination under Article 18.²⁵⁷⁸

Under some national laws, when a commercial agency contract is terminated, the agent is entitled to some form of compensation from the principal for the goodwill that the agent has created or substantially increased. In view of differing approaches of national laws to the issue of “goodwill indemnity”, the ICC Model Commercial Agency Contract incorporates two alternative solutions. First alternative provides the standard protection applicable in many national legal systems, whereas the second alternative expressly excludes a right to indemnity for the agents from countries where no legal indemnity is recognized. However, the contracting parties are advised to take into account that, if the rules of the agent’s country governing the goodwill indemnity are to be considered as “international public policy”, they may have application to the contract, or even in cases where no such legislation exists, it may be considered by the decision maker fair to grant the indemnity, particularly if this conforms to the trading practices.²⁵⁷⁹

The first alternative provides for the restitution of the benefits conferred by the agent to the principal. Accordingly, the agent is entitled to goodwill indemnification, if the agency contract is terminated in a legally valid way, under the conditions set out by Article 21.1. These conditions are: (a) the agent should have brought to the principal new customers or increased the volume of business with existing customers, and the principal continues to derive substantial benefits from those activities, and (b) the payment of indemnity should be equitable having regard to the surrounding circumstances. Pursuant to Article 21.2, the amount of indemnity will be calculated on the basis of reasonable commercial practice and not exceed a figure for one year calculated from the agent’s average annual remuneration over the preceding five years or, if the contract has lasted for less than five years, the average for the period in question. This provision follows the principle of an indemnity for a maximum period of one year, which is adopted by almost every national law awarding a goodwill indemnity.²⁵⁸⁰ According to Article 21.4, the agent shall have no right to indemnity in cases where the principal has terminated the contract for substantial breach by the agent or for exceptional circumstances, where the agent’s termination of the contract is not justified under Article 20, where the agent terminates the contract on grounds of age, infirmity or illness, and where the agent assigns his rights and duties under the contract to another person. Article 27.2 provides that if there is an assignment by the agent, the goodwill indemnity of the new agent will be calculated by taking into account the activity of the old agent, but the price paid by the old agent to the new one cannot be a basis for calculating the indemnity. Article 21.5 provides that the goodwill indemnity is in lieu of any compensation for loss or damage arising from contract expiry or termination, but Article 20.6 contains an exception and makes it clear that damages for unjustified early termination will be in addition to the indemnity under Article 21.

Moreover, pursuant to Article 19.1, the agent is entitled to commissions for orders transmitted by the agent or received by the principal from the relevant customers before the termination or expiry of the contract and which result in the conclusion of a contract for sale not more than six months after expiration or termination. This provision establishes an irrefutable

²⁵⁷⁸ Ibid.

²⁵⁷⁹ Swantee, Klaus Meyer, Article 21, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract*, A Commentary, ICC Publication No. 512, Paris, 1993, at 82-83

²⁵⁸⁰ Ibid., at 88-89

presumption that these contracts of sale are attributable to the agent's work during the agency contract.²⁵⁸¹ For orders received after the expiration or termination of the agency contract, the agent is not, in principle, entitled to commission, unless it proves that the conclusion of the transaction is mainly attributable to its efforts during the agency contract, that the conclusion of the transaction took place within a reasonable period of time after the end of the agency contract, and that the agent informed the principal in writing, before the end of the contract, of the pending negotiations which may give rise to commission. Finally, after expiry or termination of the contract, Article 22 requires the agent to return to the principal all advertising material and other documents and samples, which have been supplied to him by the principal and are in the agent's possession.

2. Arbitral Decision Making

The tension between justice in a particular case and legal certainty is clearly apparent in the case of termination of contracts. Thus, the national legal systems and international instruments adopt both some safeguards of general application, and vague standards, which enable the decision maker to account for the circumstances of a particular case. Particularly in the field of termination for non-performance, the default rules contained in those sources aim to strike a balance between the competing interests of the parties: the interests of the aggrieved party, who does not wish to continue with its performance, as it would have to extend a credit to the non-performing party with a danger that the aggrieved party would never repaid, and the interests of the non-performing party, who does not wish to lose its contractual rights when it performed its obligations to a great extent.²⁵⁸²

In international contracting practice, the parties prefer much more tailor-made clauses. These clauses regulate the conditions that justify the termination of the contract. These conditions are not necessarily limited to the non-performance of contractual obligations. The non-performance of contract is an instance of the circumstances that justify the termination of the contract. Such circumstances may also be provided by the parties in the form of the bankruptcy or insolvency of a party, where the breach of that party is anticipated, illegal acts of a party in its performance of the contract, where the other party does not wish to be involved in such practices, or the occurrence of some events that are outside of the control of the parties. In other words, the termination clauses declare the circumstances, whether it is non-performance or another event, under which the parties no longer wish to continue their contractual relationships. Moreover, the parties commonly specify the process of termination as well as its consequences. The widespread use of such termination clauses indicates that the contracting parties treat the issue of termination as a matter of risk allocation and a problem solving mechanism.

Thus, for the decision maker applying *lex mercatoria*, the termination of contract, as an inherent part of the contractual relationship, is a matter of interpretation and supplementation of the contract. Accordingly, the surrounding circumstances, nature and purpose of the contract in a particular dispute as well as the articulated rules, which contain both the contractual clauses and the default rules chosen by the parties, indicate the risk allocation

²⁵⁸¹ Matray, Didier, Article 19, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract, A Commentary*, ICC Publication No. 512, Paris, 1993, at 74

²⁵⁸² Beale, Hugh G., *Remedies: Termination*, in Arthur Hartkamp, Martijn Hesselink, Ewoud Hondius, Carla Joustra & Edgar du Perron (eds.), *Towards A European Civil Code*, Kluwer Law International, 2nd ed., 1998, at 349-350

between the parties, which determines the circumstances under which the parties wish to terminate the contractual relationship, the process that must be followed by the parties to terminate, and the consequences of such a termination.

a. Circumstances Justifying Termination

The decision maker applying *lex mercatoria* should consider the necessity of establishing a balance between the competing interests of the parties in the cases of termination. The basic principle of *pacta sunt servanda* requires the protection of the interests of the party, when he is entitled to terminate the contract upon the occurrence of certain circumstances. These circumstances are defined by the articulated rules, as non-performance of certain obligations, the changes in the parties' financial capabilities or management, or the changes in the conditions of the relevant market. In exercising his abstract reasoning, the decision maker applying *lex mercatoria* should consider that the continued performance of the obligations of the parties under the contract depends on the absence of those circumstances. However, this consideration may be subject to qualification by the basic principle of good faith and fair dealing, which requires the decision maker to take into account the interests of the other party, in order to enable the correspondence between the expectations of the parties, and to reveal their reasonable expectations. Thus, the decision maker should determine whether the existence of the circumstances, which allegedly justify the termination of the contract, actually conforms to the risk allocation that has been agreed by the parties in the underlying bargain, which may need to be ascertained by the decision maker through a contextual approach in accordance with their reasonable expectations.

ICC Case No. 8817 concerned an agreement for the exclusive distribution and sale of food products between a Spanish distributor, and a Danish principal. The contract allowed for termination without notice in the case of a substantial breach of contract, which was defined, *inter alia*, as the distributor's "lack of ability" to pay and a "substantial modification in the ownership, organization or management of the distributor". The principal terminated the contract on the basis of those grounds with immediate effect. The distributor commenced arbitral proceedings, claiming damages for unjustified termination of the contract. The contract did not contain a choice of law clause. The arbitrator considered that the CISG and its principles, as elaborated in the UNIDROIT Principles were perfectly suited to resolving the dispute, and the provisions of the contract, being the law of the parties, should apply.²⁵⁸³

As to the distributor's "lack of ability" to pay as a ground for termination, the arbitrator considered that the principal tried to change practices and usages of the parties, and "[t]he change affects the time limit for payment and the need for a continuous balance between the deliveries of goods and their payment". Referring to Article 9 (1) of the CISG and Article 1.8 of the UNIDROIT Principles on usages and practices, which the parties have established between themselves, the arbitrator stated that those modifications, wished by the principal, should have been negotiated with and accepted by the distributor. In the absence of such an agreement, the arbitrator held that the distributor's continued application of the practices previously accepted at least tacitly by the parties did not constitute a ground for termination of the contract by the principal for the distributor's lack of ability to pay the outstanding sums to the principal within the time limit set by the principal.²⁵⁸⁴

²⁵⁸³ ICC Award in Case No. 8817, 1997, Yearbook Commercial Arbitration Volume, (2000), at 359

²⁵⁸⁴ *Ibid.*, at 361

With regard to the substantial modification in the ownership, organization or management of the distributor, the arbitrator deduced from the nature of this ground, which allowed termination without notice, that it only sanctioned a substantial modification. According to the arbitrator, as is the case with all sanctions, its application could not be requested by those who were even partially responsible for the modification on which they relied in order to terminate the contract. The principal considered that the dismissal of the general manager of the distributor constituted a substantial modification in the management. The arbitrator examined the activities of the principal and the distributor's general manager, and concluded that the principal helped the general manager in his secret activities at a competitor of the distributor, by delivering to him goods of the same nature as those delivered to the distributor, which eventually led to the general manager's justified dismissal. The arbitrator held that the defendant had no relevant justification for terminating the contract on the basis of the dismissal of the claimant's general manager that the defendant partly caused.²⁵⁸⁵ Thus, the sole arbitrator decided that the principal had no ground for terminating the contract without notice and ordered the principal to pay damages.

In interpreting the termination clauses, the decision maker should determine, through a contextual approach and by considering the contract as a whole, the common intentions of the parties as to the regulation of the circumstances that justify the termination of the contract. In ICC Case No. 8362, the claimant distributor concluded an exclusive distributorship agreement with defendant manufacturer, for the distributorship in Europe of a product manufactured by the defendant. The agreement was governed by the law of New York. The agreement would continue for three years unless terminated pursuant to the termination clause, which provided for termination by mutual agreement. In the second year, the defendant decided to conclude an asset sale agreement and sold its non-core business to X. The distributorship agreement was not included among the assets transferred to X. However, following the sale, the claimant dealt with X and, in the initial months of the third year, received the defendant's products from X on the conditions previously agreed by the defendant. Eventually, the claimant learned that it had no contract with X as the distributorship agreement was not assigned, that it would no longer have distribution rights in Europe and that it would have to buy the products through X's European distributor at a higher price. The defendant responded to the claimant's inquiry as to the status of the distributorship agreement by stating that it had not assigned the agreement but it was no longer manufacturing the product.²⁵⁸⁶

The claimant argued that the defendant did not have the right to terminate the distributor agreement upon the sale to X and the defendant breached its obligations by transferring rights to the assignee that it had previously granted to claimant. The defendant argued that the supply clause of the distributor agreement allowed the manufacturer to cease entirely production of all products upon ninety days' prior notice to the claimant, and that this right constituted an independent basis for cessation of the agreement in addition to the provisions of the termination clause.²⁵⁸⁷ The arbitrator held that the plain meaning of supply clause was

²⁵⁸⁵ Ibid., at 363; It is noted that the arbitrator did not find this termination ground valid since the principal partially caused the dismissal of the general manager in the distributor's company by having delivered goods in secrecy to the manager's other company, but no legal basis for the conclusion was given. The arbitrator could have referred to Article 80 of the CISG, which provides that a party may not rely on a failure of the other party to perform, to the extent that such failure was caused by the first party's act or omission. Neumann, Thomas, Shared Responsibility under Article 80 CISG, *Nordic Journal of Commercial Law* (2/2009), at 19

²⁵⁸⁶ ICC Award in Case No. 8362, 1995, *Yearbook Commercial Arbitration*, 22 (1997), at 165-166

²⁵⁸⁷ Ibid., at 167

to allow for seasonal changes and not to allow for discontinuation of production as a ground for terminating the agreement, since the supply clause was neither included nor referenced in the termination clause. The arbitrator noted that a contrary interpretation would be inconsistent with a provision of termination clause, which entitled either party to terminate the contract upon thirty days prior notice to the other if the other party ceases to carry on business. The arbitrator further stated that even if the supply clause allowed the defendant to cease production entirely and terminate the agreement, it would be unreasonable and contrary to the principles of good faith and fair dealing to conclude that such conditions would include a sale of its product business.²⁵⁸⁸

The defendant further argued that the agreement was terminated by mutual agreement, as provided by the termination clause in the agreement, since the claimant established its own course of dealing with X on an order-to-order basis, and this conduct amounted to consent to termination of the agreement. The arbitrator rejected this argument. The arbitrator noted that the claimant was not advised of the non-assignment to X and, thus, the claimant understood that the agreement remained in effect and pursued its business relationship with X on the basis that it retained its right under the distributorship agreement. Moreover, the arbitrator considered that the claimant's ultimate position in the X distribution network was the subject of negotiations with X, and the claimant was entitled to expect that it might be able to retain essentially the same rights that it enjoyed under the distributor agreement, thereby avoiding the need for litigation.²⁵⁸⁹ The arbitrator held that no right of termination was allowed under supply clause and no termination occurred pursuant to termination clause, or by waiver and, thus, the defendant's actions in assigning to X rights reserved to claimant under the distribution agreement constituted a breach thereof.²⁵⁹⁰

Since it is considered as part of the reasonable expectation of each contracting party, on which its own obligation is based that the other party will perform its obligations, the non-performance of the other party's obligation is treated in all legal systems as the most important reason to terminate a contract.²⁵⁹¹ Thus, it is generally argued in the doctrine that arbitrators treat a party's right to terminate the contract for other party's failure to perform or lack of proper performance as a general principle of law.²⁵⁹² In the Lena Goldfields arbitration, the tribunal, applying general principles of law, decided that the conduct of the Government, which resulted in a total impossibility for Lena of either performing the Concession Agreement or enjoying its benefits, was a breach of the contract going to the root of it and, thus, Lena was entitled to be relieved from the burden of further obligations thereunder and to be compensated in money for the value of the benefits of which it had been wrongfully deprived.²⁵⁹³ In the Sapphire award, the arbitrator stated that "There is a general

²⁵⁸⁸ Ibid., at 169

²⁵⁸⁹ Ibid., at 170

²⁵⁹⁰ Ibid., at 171

²⁵⁹¹ Schlechtriem, Peter, Termination of Contracts under the Principles of International Commercial Contracts, in Michael Joachim Bonell & Franco Bonelli (eds.), *Contratti commerciali internazionali e Principi UNIDROIT*, Giuffr , Milano 1997, at 249

²⁵⁹² Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 831; Mustill, Michael, *The New Lex Mercatoria: The First Twenty-five Years*, Arbitration International, (1988), at 113; Lowenfeld, Andreas F., *Lex Mercatoria: An Arbitrator's View*, Arbitration International, (1990), at 148

²⁵⁹³ Nussbaum, Arthur, *The Arbitration between the Lena Goldfields, Ltd. and the Soviet Government*, Cornell Law Quarterly, 36 (1950), at 51

rule of private law to be found in positive systems of law, which says that a failure by one party to a synallagmatic contract to perform its obligations in breach of contract releases the other party from its obligations and gives rise to a right to pecuniary compensation in the form of damages. Although the methods of applying this principle differ, particularly with regard to judicial techniques and the formalities required for the implementing of this right, this rule is a general rule, and constitutes a general principle of law recognized by civilized nations.... However different the judicial techniques employed may be, however divergent may be the theoretical explanations given by doctrine, one point is certain: this principle is explained by the interdependence of the obligations contained in the same contract. It would be illogical and contrary to the most elementary notions of equity if one party could obtain satisfaction while the other suffered a loss. Whether the notion of the reciprocal effect of obligations, of the equal value of obligations, or of the implied condition is relied on, it is impossible to escape the essential and elementary conclusion that one of the parties must not benefit from the performance of the contract by his partner while evading his own obligations. The disregarding of the contractual law by one of the parties releases the other from its undertakings.”²⁵⁹⁴

Due to the concern for striking a balance between the interests of the parties in the cases of termination of contract, the national legal systems are based on a basic principle for the termination of contracts, namely that there must be an actual or imminent breach of a certain degree of seriousness.²⁵⁹⁵ The existence of a serious breach implies the absence of a substantial performance by the party in breach. In this context, substantial performance by a party prevents the other party from terminating the contract. For example, the breach of minor obligations alone does not give rise to the right of the aggrieved party to terminate the contract, or the party in breach is given a fair opportunity to remedy its defective performance if this is reasonable. The interests of the aggrieved party in substantial performance of the other party are also protected through the mechanisms of anticipatory breach or adequate assurances for performance. Although these mechanisms have not been uniformly adopted across the national legal systems, it can be said, in abstract terms, that most of the national legal systems as well as international instruments have opted for the default standard of substantial performance over that of perfect tender, which enhances the risk of strategic behavior and moral hazard on the part of the creditor, who may opportunistically take advantage of the possibility to reject any tender which is less than perfect and to refuse a substantially correct performance, whenever he seeks to free himself from his obligations promised in consideration of the debtor’s full performance.²⁵⁹⁶

The decision maker applying *lex mercatoria* should apply this established rule in the order of international commerce that a party is entitled to treat itself as discharged from its obligations only if the other has committed a fundamental or material breach. In the application of this rule, the decision maker should refer to the terms of the contract in determining whether the non-performance of a particular obligation justifies the termination of the contract by the other party on the basis of the risk allocation agreed by the parties. The characterization of the

²⁵⁹⁴ *Sapphire International Petroleum Ltd. v. National Iranian Oil Co.*, ad hoc award of 15 March 1963, *International Legal Report*, 35 (1967), at 182-183

²⁵⁹⁵ Schlechtriem, Peter, *Termination of Contracts under the Principles of International Commercial Contracts*, in Michael Joachim Bonell & Franco Bonelli (eds.), *Contratti commerciali internazionali e Principi UNIDROIT*, Giuffr , Milano 1997, at 251

²⁵⁹⁶ Torsello, Marco, *Remedies for Breach of Contract*, in Jan Smits (ed.), *Elgar Encyclopedia of Comparative Law*, Edgar Elgar Publisher, Aldershot, 2006, at 612

relevant obligation as an undertaking to achieve a specific result or to use one's best efforts may be directly relevant to the determination of whether the termination is justified on the ground of fundamental non-performance. In the commercial agency contracts, the agent usually undertakes to use its best efforts to achieve a certain volume of the sales of the products of the supplier thereby assigning the risk of underachievement to the supplier, who may not terminate the agreement on that ground. In ICC Case No. 10422, which concerned an agreement for the exclusive distribution of a European manufacturer's products in a Latin-American distributor's country, the manufacturer terminated the agreement alleging the distributor's failure to meet the contractually agreed sales figures. The distributor argued that the termination was ineffective because the sales figures indicated in the agreement were not binding commitments. The tribunal, having decided to apply the general rules and principles of international contracts, noted that contrary to widespread contracting practice, the agreement did not expressly state that the failure to meet the agreed sales figures permits the supplier to terminate the contract. Considering that the agreement merely stated that the parties agreed on determined sales objectives and contained no obligation on the distributor's part to guarantee that such a result would be achieved, the tribunal stated that the failure to meet the purchase objectives did not, in itself, amount to a breach of contract and, thus, cannot be considered a justifiable reason for termination in advance.²⁵⁹⁷

Moreover, in cases where the parties explicitly provided remedies other than termination of the contract for the breach of a particular obligation, the decision maker should take into account the relevant contractual clauses, which indicate an allocation of risks between the parties, in determining whether the termination of the contract for the non-performance of such an obligation is justified. In a case in the Camera Arbitrale Nazionale ed Internazionale di Milano, the principal terminated an exclusive agency contract, alleging unsatisfactory sales results. The agent initiated arbitral proceedings invoking unlawful termination by the principal and claiming damages. The contract did not contain a choice of law clause but, at the outset of the arbitral proceedings, the parties agreed that the arbitrator would decide *ex aequo et bono* and apply the UNIDROIT Principles. Article 18 of the contract allowed either party to terminate the contract "before its expiry or renewal if the other party shall find that this agreement has been violated by the other party and the violation has not been cured."²⁵⁹⁸ Referring to Article 1.3 of the UNIDROIT Principles, which contains the principle of *pacta sunt servanda*, the arbitrator took into account another provision of the contract, where the parties explicitly intended that in case the sales target were not met, the parties were to decide by agreement whether to renegotiate the area and/or the commission fees. Moreover, the arbitrator interpreted Article 18 of the contract in the sense that non-performance under the contract should be communicated to the non-performing party, so that the latter could, if possible, remedy such non-performance, but no oral or written warning preceded the termination notice of the principal. The arbitrator also considered Article 7.3.1 of the UNIDROIT Principles on the question of fundamental non-performance as a requirement for termination, and concluded that "it seems impossible to deem fundamental for the termination a situation which was explicitly and expressly provided for by the parties to the contract as being renegotiable, by an agreement of the parties, as to the area or the commission fees."²⁵⁹⁹

²⁵⁹⁷ ICC Award in Case No. 10422, 2001, Excerpts of the original French version of the award have been published in *Journal du droit international*, (2003), pp. 1142-1150 Available in English at <http://www.unilex.info/case.cfm?pid=2&do=case&id=957&step=FullText>

²⁵⁹⁸ Chamber of National and International Arbitration of Milan, Final Award in Case No. 1795, December 1, 1996, *Yearbook Commercial Arbitration*, 1999, at 196-197

²⁵⁹⁹ *Ibid.*, at 200

Thus, the arbitrator held that the unilateral termination of the agency contract was not justified.²⁶⁰⁰

Under the transactions governed through legal uncertainty, the decisive factor in determining whether a non-performance is fundamental to justify the termination by the aggrieved party will usually be the extent of the detrimental effect of the breach on the aggrieved party's reasonable expectations from the contractual relationship and from the breaching party's future performance, which is also expressed in Article 7.3.1. (2) (d) of the UNIDROIT Principles, and in Article 8:103 (c) of the PECL. In *Sapphire Award*, the arbitrator found that the defendant, although having carried out one of its principal obligations, failed to collaborate closely with its partner under the contract, and showed its intention to refuse to collaborate loyally by its clearly unjustified grievances. The arbitrator considered this behavior of the defendant as a means to convince the plaintiff that the defendant intended to avoid the contract by continuous and systematic obstruction, but without wishing to be the first to denounce it. Thus, the arbitrator held that the defendant's behavior was likely to destroy any confidence their partner had, and in these circumstances, the defendant could not reasonably or in good faith require that the plaintiff should still be bound to proceed with the contract.²⁶⁰¹

In ICC Case No. 3267, the dispute arose from the termination of the contract by the claimant, a Mexican construction company, which was sub-contracted by the defendant, a Belgian company, in relation to a part of a construction project in Saudi Arabia. In the proceedings, the claimant sought for a declaration that the contract had been terminated legitimately for the defendant's payment defaults. The contract authorized the arbitrators to decide as amiable composituers, and the arbitrators decided to apply "the widely accepted general principle governing commercial international with no specific reference to a particular system of law."²⁶⁰² The arbitrators first looked at the nature of the contract and characterized the contract as a lump sum contract setting forth a fixed price subject to modifications only in limited cases set out by the contract. The arbitrators stated that "Consistent with this principle of a lump sum contract, and more particularly with an international agreement drafted in English and using the Anglo-American approach of spelling out very detailed provisions entailing correspondingly strict adherence thereto, the parties have in effect agreed that the Contract's price was not to be modified in case of failure by the Contractor to meet its obligations as regards quality of the Works to be performed and of the equipment to be supplied; in such cases, the remedy available to Defendant during the construction period was to request the Contractor, as spelled out in ... the Contract, to remove and replace at its own cost any material not conformity with the contractual standards and specifications and to re-execute at his own cost the Works, which did not meet such standards. Pursuant to [the Contract], had the Contractor not started corrective action within a 10 day period, after request by ... Defendant, ... Defendant had the right to employ other contractors at Contractor's expenses." The arbitrators considered that, under such a contract, the failure of the contractor to meet its obligations concerning the conformity and the quality of the equipment and services supplied had no direct impact on the contract price or on the payment procedure and such a failure was to be remedied by the specific procedures set out in the contract. The arbitrators observed that "when attempting to justify its payment withholding to

²⁶⁰⁰ Ibid., at 201-206

²⁶⁰¹ *Sapphire International Petroleum Ltd. v. National Iranian Oil Co.*, ad hoc award of 15 March 1963, *International Legal Report*, 35 (1967), at 185

²⁶⁰² ICC Award in Case No. 3267, 14 June 1978, *Yearbook Commercial Arbitration*, (1982), at 98

Claimant, Defendant identified specific grounds spelled out in the contract, and did not relate it to, or invoke, Claimant's failure to perform under its general obligations as contractor."²⁶⁰³

Thus, the arbitrators sought to establish whether the defendant's payment defaults justified termination by the claimant, and whether the claimant's termination was in compliance with the contract, which particularly required that claimant's termination should not be arbitrary. Under the circumstances, the normal contractual remedy available to the defendant under the contract was either to seek with the claimant an agreed upon amendment or to request the claimant to suspend the progress of the works, being subject to financial obligations spelled out in the contract. The arbitrators found that the defendant never attempted to negotiate a settlement with the claimant and, rather than applying the existing contractual procedure of suspension, elected to make unilaterally a deduction in an amount which it fixed itself. Moreover, the arbitrators considered that the abruptness of its deduction without advance warning was not in keeping with the good faith spirit which should have prevailed in the performance of the contract. Thus, the arbitrators held that the defendant had no right to make unilateral deduction and, in doing so, failed to pay the claimant amounts which had become due under the contract.²⁶⁰⁴ Subsequently, the arbitrators found that the claimant had met all the formal requirements for termination under the contract. As to the issue of arbitrariness of termination, the arbitrators considered that the amount in dispute was substantial, even if it represented only a percentage of about 3.35% of the total amount of the contract price. According to the arbitrators, the claimant's operations under the contract were clearly underfinanced and the non-payment of the amounts due was very likely to jeopardize the financial capability of the claimant to continue performance under the contract. More importantly, the arbitrators noted that the defendant's attitude was very rigid in its refusal to pay, and the defendant had already taken preliminary steps to have the claimant replaced by another company.²⁶⁰⁵ Thus, the arbitrators held that the contract was terminated legitimately and not arbitrarily by the claimant in accordance with its terms.

The failure of the party to cure its defective performance when it is invited by the aggrieved party to do so may become an important factor for the decision maker in determining whether the termination for fundamental non-performance is justified on the ground that the non-performance gives the aggrieved party reason to believe that it cannot rely on the other party's future performance. In a case decided under the auspices of Stockholm Chamber of Commerce, the claimant and the defendant concluded an agreement for the license and manufacture of certain products in China, but the factory never reached the production stage and was closed by the defendant. The claimant terminated the contract since the agreement placed the responsibility for the setting up of the plant and for the manufacture and production basically on the defendant. The contract did not contain a choice of law clause, and the arbitral tribunal decided to apply Chinese law to the substance of the dispute. The arbitral tribunal considered the closure of the plant by the defendant as an indication that, in view of the totality of existing deficiencies in the plant, the defendant saw no possibility to get production started and to usefully continue to perform its duties. The tribunal took into account the fact that the breach of contract was never actually cured by the defendant despite notifications by the claimant. Thus, the tribunal concluded that the breaches of contract by the defendant were so serious and enduring as to entitle the claimant to give notice of termination,

²⁶⁰³ Ibid., at 99

²⁶⁰⁴ Ibid., at 100

²⁶⁰⁵ Ibid., at 102

and the defendant was liable in damages towards the claimant. The tribunal also rejected the defendant's argument that under Chinese law, the claimant was not entitled to terminate and instead had a right merely to suspend the contract. According to the tribunal, suspension was an alternative remedy that was open to the claimant, but in the prevailing situation, where the defendant consistently failed to cure its breaches of contract after notification, it was not mandatory.²⁶⁰⁶

In another case concerning the request for termination, the claimant, a U.S distributor, terminated a one year exclusive sale and distribution agreement and brought an action before the Centro de Arbitraje de México against the defendant, a Mexican grower, arguing that the defendant had breached the contract by not providing the goods referred to in the contract and by violating the exclusivity clause. The UNIDROIT Principles were applicable in the case as a result of the choice of parties to that effect. In the arbitral tribunal's opinion, the non-performance by the defendant was fundamental since at least three of the criteria laid down in Article 7.3.1 (2) were met: first, the defendant's failure to deliver deprived the claimant of the goods it was entitled to expect under the contract; second, the defendant's violation of the exclusivity clause was intentional; and, third, these two circumstances were enough to give the claimant reason to believe that it could not rely on the defendant's future performance. Thus, the tribunal held that the contractual violations of the defendant constituted a "fundamental breach" under Article 7.3.1 of the UNIDROIT Principles, and enabled the claimant to exercise its right to terminate the contract in accordance with Article 7.3.2 of the UNIDROIT Principles.²⁶⁰⁷

In ICC Case No. 9797, i.e. Andersen case, Andersen Worldwide Société Coopérative ("AWSC"), was found by the tribunal to be obliged under the Member Firm Interfirm Agreements ("MFIFAs") within the Arthur Andersen Group to exercise its best efforts to ensure co-operation, co-ordination, and compatibility between the practices of Andersen Consulting Business Unit member firms ("ACBU") and Arthur Andersen Business Unit member firms ("AABU"). Referring to the criteria set forth in Article 7.3.1 (2) of the UNIDROIT Principles, the tribunal found that the AWSC's failure amounted to a fundamental non-performance on the basis of following considerations: first, AWSC's failure to exercise its best efforts to co-ordinate the member firms' practices substantially deprived ACBU members of the co-operative benefits they were entitled to expect under MFIFAs²⁶⁰⁸; second, strict compliance with the obligation to co-ordinate was of the essence of MFIFAs, as co-ordination amongst member firms was the 'cornerstone' of these agreements²⁶⁰⁹; third, AWSC's non-performance gave ACBU members reason to believe that they could not rely on AWSC's future performance²⁶¹⁰; and fourth, AWSC could not possibly suffer a disproportionate loss as a result of the preparation or performance if ACBU member firms' MFIFAs were terminated, because AWSC was an instrumentality for the purpose of

²⁶⁰⁶ SCC Final Award, July 13, 1993, Yearbook Commercial Arbitration, (1997), at 207

²⁶⁰⁷ Centro de Arbitraje de México (CAM), Award dated 30 November 2006, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1149&step=Abstract>

²⁶⁰⁸ ICC Award in Case No. 9797, July 28, 2000, Andersen Consulting Business Unit Member Firms vs. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative, World Trade and Arbitration Materials, 12-5 (2000), at 184

²⁶⁰⁹ Ibid., at 183-184

²⁶¹⁰ Ibid., at 185

coordinating the member firms' professional practice and would only be paid as long as the inter-firm agreements remained in force.²⁶¹¹

The last factor that was taken into account by the tribunal in ICC Case No 9797 in determining fundamental non-performance is that of Article 7.3.1 (2) (e) of the UNIDORIT Principles, i.e. whether the non-performing party will suffer disproportionate loss as a result of the preparation or performance if the contract is terminated. Similarly, the tribunal in the Ad Hoc Award dated November 3, 1977, took into account this factor of reliance, and found that the party exercising its right to terminate was liable for damages resulting from its termination of the contract. In the case, the arbitrators, empowered to decide as amiable composituers, were asked to decide on the claim that the contract was terminated under circumstances devoid of all good faith. The dispute arose from a license contract whereby MMM, a Belgian company, granted part of its exclusive distributorship to Mechema, an English company. Mechema initiated arbitral proceedings claiming that MMM's termination was without sufficient notice and contrary to good faith. Mechema argued that MMM had devised a business plan which would disloyally set Mechema aside in favor of one of MMM's own branch, and this branch was to hire Mechema's sales managers, who had a thorough knowledge of the organization and its clients. MMM responded that it had terminated the contract because of Mechama's lack of interest and competing industrial activities and it had notified Mechema as prescribed by the contract. The arbitrators decided to apply *lex mercatoria* to the substance of the dispute in the exercise of their power as amiable composituers. The arbitrators found that there was no plan to set Mechema aside, and the hiring of those employees did not constitute a disloyal action. Moreover, the arbitrators considered that Mechema had become a competitor to MMM, rather than a concessionaire in regard to their clients. While admitting that MMM had the right to terminate the contract in accordance with the stipulated notice of three months in advance, the tribunal considered the exercise of this right in the particular circumstances as a violation of equity since, even if devoid of any intention of causing damage, there was disparity between the advantage that the exercise of the right to terminate procured to MMM and the damage which results therefrom for Mechema, particularly under a sale concession agreement by which two companies were linked together for long-term operations and where termination of relations especially affects the concessionaire.²⁶¹² Thus, the arbitrators held that damages should be awarded to Mechema.

The intention of one the parties to terminate the contract, even if it results in a disproportionate loss to the other party or it is otherwise unfounded, may imply the rupture of continuing relationship between the parties, particularly when the contractual relationship requires the existence of a certain degree of cooperation. Thus, even if termination by one party is not justified, the decision maker applying *lex mercatoria* should take into account the negative impact of a termination notice, which will often lead to a loss of confidence between the parties, making it difficult for them to continue to work together. In those cases, unlawful termination should effectively end the contractual relationship, enabling the aggrieved party to claim damages.²⁶¹³ In ICC Case No. 10422, as to the effects of an unjustified termination of

²⁶¹¹ Ibid., at 185-186

²⁶¹² Ad hoc Award, November 3, 1977, Mechema Ltd vs. S.A. Mines, Minerais et Metaux, Yearbook Commercial Arbitration, 7 (1982), at 80

²⁶¹³ ICC (Final) Award in Case No. 5946, 1990, Yearbook Commercial Arbitration, (1991), at 109: The arbitrator applying New York law to an exclusive agency agreement stated that "This termination of the Agreement was legally effective irrespective as to whether it was justified." Ad Hoc UNCITRAL Award of 17 November 1994, Banque Arabe et Internationale d'Investissements et al v Inter-Arab Investment Guarantee

a contract, the tribunal observed that in civil law systems, unjustified termination is ineffective, with the result that such a contract will remain in force and the parties will continue to have to fulfill their obligations, whereas, in common law systems, even an unjustified termination puts an end to the contractual relationship, and the party who has unjustifiably terminated the contract is liable for damages to compensate the loss the other party has suffered. The tribunal considered that the second approach, which has the advantage of certainty in contractual relationships, is the one generally adopted in international trade law. According to the tribunal, the UNIDROIT Principles confirmed this point of view by providing in Article 7.3.2(1) that “The right of a party to terminate the contract is exercised by notice to the other party”, and in Article 7.3.5(1), that “Termination of the contract releases both parties from their obligation to effect and to receive future performance.” Accordingly, the tribunal decided that a notice of termination is effective even if unjustified with the result that the other party may not require specific performance of the contract but can only claim damages for the unjustified termination.²⁶¹⁴

The decision maker applying *lex mercatoria* may deem the breach of an implied obligation by a party as so substantial that the aggrieved party may no longer reasonably expect the possibility of proceeding with the contractual relationship. In such a case, the decision maker may interpret the articulated rules to the effect that the aggrieved party is enabled to terminate the contract without following the process set out by the contract regulating the termination for the violation of specific contractual obligations. In this sense, the termination of contract for the violation of implied obligations can be considered as an instance of the termination for just cause under some national legal systems, to the extent the termination of contract is justified on the ground that the reasonable expectations of the aggrieved party from the future of the contractual relationship are substantially impaired by the conduct of the other party.

In an award rendered under the auspices of Italian Arbitration Association, the arbitral tribunal considered that the breach of an implied obligation to cooperate by one party could justify the termination by the other party of an exclusive distributorship contract without following the procedures set out in the contract for its termination. The parties chose Italian law as the applicable law. The claimant, the Danish distributor, commenced arbitration proceedings against the defendant, the licensee for Europe of a fashion product and its trademark, seeking termination of the distributorship contract and damages. The claimant argued that the defendant breached its obligation to protect the trademark and the claimant was compelled to undertake expensive court proceedings in the country of the original licensor. The contract provided that the defendant and its licensor were responsible for the protection and maintenance of the trademarks in connection with the products in the territory, and would bear all costs and expenses relative to such protection and maintenance in the

Corporation, Yearbook Commercial Arbitration, (1996), at 36-37: The tribunal applying the common legal principles prevailing in the Arab world and international law at large stated that, in the case of an unjustified termination of a loan guarantee agreement, the aggrieved party had the right either to withhold performance of such of its obligations as were correlative to the unperformed obligations of the other party or to treat the contract as terminated and sue for compensation in lieu of performance, which occurred in this case. Chamber of National and International Arbitration of Milan, Final Award in Case No. 1795, December 1, 1996, Yearbook Commercial Arbitration, (1999), at 201-206: The sole arbitrator, applying UNIDROIT Principles to the question of unlawful termination of contract in a case dealing with an exclusive agency contract, held that, upon unfounded termination, both parties were freed of their obligations and could no longer rely on their rights under the contract.

²⁶¹⁴ ICC Award in Case No. 10422, 2001, Excerpts of the original French version of the award have been published in *Journal du droit international*, (2003), pp. 1142-1150 Available in English at <http://www.unilex.info/case.cfm?pid=2&do=case&id=957&step=FullText>

territory.²⁶¹⁵ According to the claimant, the defendant should have acted for the protection of the trademark against parallel imports in the claimant's territory of products coming from the country of the original licensor of the defendant. The defendant argued that it had satisfied its obligation to defend the trademark by putting together a team of lawyers with the task of combating parallel imports in Europe.

The arbitral tribunal noted that the contractual clause provided for defendant only an obligation to protect the trademark, without saying anything about the means to be used to engage in such protective action and, thus, the defendant was free to adopt the strategy considered most appropriate. However, the tribunal maintained that, even though the defendant may not have had the duty to engage in specific legal actions against exporters and/or parallel importers, it should at least have cooperated with claimant, providing it with appropriate support. In the tribunal's opinion, "it is true that strictly such a contractual duty of cooperation in the event of legal proceedings was provided to be borne only by claimant, in the case of similar initiatives being undertaken by defendant or its licensor, but this does not mean that, in general terms, a similar duty of assistance and cooperation should not be borne by defendant in the converse case, that is on the basis of the duty under Art. 1375 CC to perform a contract in accordance with good faith, 'to be understood as an "undertaking of cooperation and protection of the interests of the other party to the contract", operating "beyond the specific provisions" of the agreement and not capable of exclusion by the will of the parties'".²⁶¹⁶

Thus, the tribunal held that there was a conduct not in compliance with the principle of good faith since the defendant failed to give due cooperation to claimant, when the latter embarked upon its own legal actions against the exporters in the country of the original licensor. The tribunal considered that, according to Article 1453 of the Italian Civil Code, a party in compliance with the contract may request the cancellation of the contract when the other party is in breach and Article 1455 provides that the cancellation may not be adjudicated if the breach is of little importance. The tribunal stated that "defendant, on account of its insufficient defence of the trademark, has breached the fundamental principle of performance in good faith (Art. 1375 CC). It is thus in breach in relation to claimant, fatally flawing the possibility of proceeding with the contractual relationship between the parties."²⁶¹⁷ However, the claimant had not followed the termination procedures set out in the contract, which required the aggrieved party to notify the other in writing requesting correction and, in the event of failure to correct within the following twenty days, the aggrieved party would have the right to terminate by giving simple notice to that effect. Instead, the claimant had simply informed the defendant that it would have recourse to arbitration proceedings in order to obtain termination of the contract.²⁶¹⁸ The tribunal noted that the claimant failed to implement the procedure contractual envisaged and to insist on performance prior to being able to invoke the effect of termination. According to the tribunal, the parties were in a state of mutual breach, and, referring to Italian case law, determined that the culpable breach was committed by the defendant, whose conduct was such as to preclude any future possibility of working together as had been foreseen by the parties at the time of making the contract. Thus, the

²⁶¹⁵ Italian Arbitration Association, Final Award in Case No. 76/98, November 24, 1999, Yearbook Commercial Arbitration, (2000), at 376

²⁶¹⁶ Ibid., at 377

²⁶¹⁷ Ibid., at 380

²⁶¹⁸ Ibid., at 379

arbitral tribunal pronounced the termination of the contract for the overriding fault of the defendant.²⁶¹⁹

b. Termination Process

Under *lex mercatoria*, even if the particular circumstances of the case justify the termination of the contract by a party, such a party is still, in principle, required to follow the process of termination set out by the terms of contract or the applicable default rules, for the validity of termination. Under national legal systems, the process of termination of the contract in cases of non-performance is essentially aimed at controlling the uncertainty arising from the standards of substantial performance or serious non-performance and, thus, the ground and process of termination are closely intertwined. Some legal systems provide a fallback line for cases where the seriousness of breach might be uncertain, by the instrument of a request of the aggrieved party, which makes the obligation of the essence by setting a period of grace, while other legal systems are based on a general requirement that the aggrieved party first has to set an additional period of time to allow the non-performing party a second chance, but that such an additional period of time is considered unnecessary in cases of an obviously fundamental or incurable breach.²⁶²⁰ In both cases, since the delicate balancing of interests that is required in termination for non-performance cases is pre-eminently a matter of interpretation and judicial discretion, an evaluation of reasonable expectations of the parties with regard to the process of termination is indispensable almost in every case.

Some legal systems generally require the aggrieved party to seek termination in legal proceedings before a court. This requirement can be considered as a result of the prevalence of the idea of enforceability of contractual promises over the determination of available remedies for non-performance. In those legal systems, the enforceability of contract blends with the available remedy for non-performance, which leads to the conclusion that termination must be judicial so that, once bound, the parties may not set themselves free from the contract, unless the parties clearly indicate their intentions to that effect, or the conduct of the debtor makes the continuation of the contractual relationship impossible or unbearable for the creditor. In this context, contracts are meant to be performed and, since termination is opposed to performance, specific performance is naturally considered to be the primary remedy, which is no longer distinguished from the enforceability of contracts.²⁶²¹

However, the enforceability of contracts means that the connection established between the parties is legally enforceable. It is embodied in the principle of *pacta sunt servanda* that a party who does not abide by his contractual obligations is subject to a sanction, in the same way as any individual who does not respect the law. Because its conduct does not comply with the norm, the party in breach of contract shall be liable to accept the remedial consequences of the infringement. Thus, enforceability should not be confused with the remedies for breach of contract. In essence, there is no opposition between the principle of enforceability of contracts and termination of the contract.²⁶²² The former allows legally

²⁶¹⁹ *Ibid.*, at 380

²⁶²⁰ Schlechtriem, Peter, *The German Act to Modernize the Law of Obligations in the Context of Common Principles and Structures of the Law of Obligations in Europe*, Oxford U Comparative L Forum, 2 (2002), at ouclf.iuscomp.org, text after note 37

²⁶²¹ Laithier, Yves-Marie, *Comparative Reflections on the French Law of Remedies for Breach of Contract*, in Nili Cohen & Ewan McKendrick, *Comparative Remedies for Breach Of Contract*, Oxford: Hart, 2005, at 117

²⁶²² *Ibid.*

formed agreements to penetrate the sphere of the law, so that the contract becomes legally enforceable. The latter, as with any other remedy, requires a balance to be struck between the conflicting interests of the parties in the presence of a contractual dispute in order to give effect to the reasonable expectations of the parties. In cases of termination of contract, the principle of good faith and fair dealing requires the decision maker to take into account not only the interests of the aggrieved party, but also those of the non-performing party in determining whether termination is justified. However, the enforceability should not be concerned with determining the scope of the remedies available to the parties without obtaining a judicial order.

Unless the parties chose the default rules of those national legal systems that require a judicial decision for the termination of the contract, the decision maker applying *lex mercatoria* should consider termination of contract as a form of self-help remedy, which can be done without obtaining a judicial order, in accordance with the approach of many national legal systems and international instruments. Thus, the decision maker may consider as idiosyncratic and disregard the rules of those national legal systems that require a judicial decision for termination, when they are applicable to the substance of the dispute pursuant to the established rules of conflict. The aggrieved party may terminate the contract by giving notice to the other party. Unless there are circumstances justifying immediate termination without notice, the period of notice may also be considered as a prerequisite for the exercise of the right to terminate the contract, since the notice period mitigates the harsh consequences of termination by enabling transition particularly in long term relationships. Moreover, the decision maker applying *lex mercatoria* should consider at an abstract level the contracting practices of drafting termination clauses in terms of problem solutions, which incorporate into those clauses the safeguards against termination under the national legal systems, such as the mechanisms of adequate assurance, *Nachfrist* and cure. On the basis of such an abstract reasoning, the decision maker should determine, in the context of the specific circumstances of the case, the proper process of termination by taking into account the degree to which each party is entitled to good faith cooperation from the other, the extent to which the aggrieved party should be entitled to get exactly what was promised to him, the importance of the particular obligation for the aggrieved party and the foreseeability of this importance for the non-performing party, and the level of need for preserving the contractual relationship even when things have gone wrong by giving additional chances to perform.

In most cases, the decision maker may determine the validity of the process of the termination of the contract by examining the terms of the contract and facts of the case. Thus, the decision maker applying *lex mercatoria* should consider the contractual clauses, the nature and purpose of the contract, as well as the surrounding circumstances in deciding on the question of whether the right to terminate the contract is effected through a proper process. In ICC Case No 9797, i.e. Andersen case, the tribunal held that AWSC's conduct amounted to a fundamental nonperformance of its obligations under the MFIFAs. AWSC argued that the ACBU member firms ignored the termination provisions of MFIFAs. The tribunal examined the MFIFAs' relevant provisions as to the process of termination. MFIFA allowed a member firm or AWSC to terminate the member firm's MFIFA upon receipt of a notice of termination in the event of breach or default. The tribunal noted that Paragraph 14 of the MFIFAs enumerated several termination events, among them, the provision governing unilateral termination by a wronged party and, separately from the unilateral termination clause, the MFIFAs also contained certain arbitration provisions for the resolution of any and all disputes which cannot be settled amicably, arising out of or in connection with the MFIFAs (Paragraph 22.1 of the MFIFAs) and regardless of whether the complaining party seeks to be released

from its obligations under the MFIFAs. According to the tribunal, those two paragraphs clearly regulated different events and offered a wronged party the alternative rights to terminate its MFIFA when a material breach has occurred or to resort to arbitration in search of a final decision that will resolve a dispute with another party. The tribunal stated that while, in the event of unilateral termination, the notice of breach was an essential condition for the aggrieved party to be relieved from its obligations insofar as it set in motion the procedure regulated in Paragraph 14.2 (F), such notice was not established, as a condition precedent to the commencement of an arbitration proceeding. The tribunal held that the ACBU member firms elected to exercise their right to arbitration under Paragraph 22 of the MFIFAs, instead of unilaterally terminating their MFIFAs and therefore were not under the obligation to serve AWSC with a notice of breach, and they did not file the arbitral proceeding in disregard of the notice provisions contained in the MFIFA.²⁶²³ Thus, the tribunal held that on account of AWSC's fundamental non-performance, the ACBU member firms were released from all their obligations to AWSC and the AABU member firms under the MFIFAs as of the date the award was notified to the parties.²⁶²⁴

In ICC case No. 9839, the claimant Q Inc., an international mergers and acquisitions firm, specializing in cross-border transactions, had entered into an agreement with the defendant Q-Z. Pursuant to the agreement, the defendant became the exclusive representative of the claimant in the United States for the so-called “pipeline deals”. The parties chose the law of New York as the applicable law. From the inception of the agreement, the claimant and the defendant had differences, which culminated in the termination of the agreement a few months later. The agreement contained a mixture of different grounds and procedures for termination, each having different effects on the rights and obligations of the parties. Clause 8(1) allowed either party to terminate the agreement for any reason upon one month’s notice. Clause 8 (3) provided that the agreement could be terminated in the event of “a breach by the other party of any material term of the Agreement, which remains unremedied for 21 days after receiving written notice thereof.” Clause 9 (2) (1) of the agreement provided that, if the agreement was terminated in accordance with Clause 8 (3), the representative would not be entitled to a portion of any future gross fee income to which it would otherwise be entitled for all transactions initiated during the term of the agreement but concluded after its termination.²⁶²⁵

The claimant terminated the agreement in accordance with Clause 8 (1) due to the defendant’s poor performance. However, before the termination, the defendant had been involved in the acquisition of a company, and it received a success fee for the transaction from the acquirer.

²⁶²³ ICC Award in Case No. 9797, July 28, 2000, Andersen Consulting Business Unit Member Firms vs. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative, World Trade and Arbitration Materials, 12-5 (2000), at 196-197

²⁶²⁴ Ibid., at 210; In the discussions of the Working Group for the preparation of UNIDROIT Principles 2010 as to the rules on termination of long term contracts for just cause, the Andersen case was mentioned as a good example, where due to supervening circumstances, the fiduciary relationship on which relational contracts by their very nature are based was irremediably destroyed and where the only appropriate remedy was the ending of the contract with immediate effects. UNIDROIT 2006 - Study L - Misc. 26, October 2006, at 38; It is argued that arbitral tribunal had considerable difficulty in justifying the termination of the agreement with immediate effects by merely relying on the terms of the contract and Articles 1.7 and 7.3.1 of the UNIDROIT Principles. It is suggested that the same result could have been justified in a much more linear and convincing manner if there had been provisions on termination of long term contracts for just cause. UNIDROIT 2008 - Study L - Misc.28, October 2008, at 68

²⁶²⁵ ICC Award in Case No. 9839, 1999, Yearbook Commercial Arbitration, (2004), at 73

Pursuant to the fee sharing arrangement of the agreement, the defendant was obligated to pay the claimant a percentage of the success fee. The defendant failed to remit the fee to the claimant. Several days after having notified the defendant that the contract was terminated in accordance with Clause 8 (1), the claimant also notified the defendant that it considered the defendant's failure to remit the fee a material breach of the agreement. The agreement terminated twenty-one days after the notice and several months later, the claimant initiated arbitration proceedings, arguing that the defendant's material breach of the agreement precluded it under Clause 8 (3) from sharing any gross income fee. The defendant responded that since the claimant failed to terminate the agreement according to the agreement's procedures and the claimant's termination of the agreement was in a bad faith, the defendant was released from any contractual obligation to pay.

First, the tribunal found that the defendant materially breached the agreement by failing to pay the contractual percentage from the fee, since, pursuant to the agreement, the defendant was required to transmit the relevant amount to the claimant "without delay", but the defendant withheld the claimant's portion for a variety of purported reasons after the claimant's initial notice of termination and, failed to cure the breach within the twenty-one days' notice period.²⁶²⁶ Then, the tribunal held that the defendant was barred from recovering any fees it could otherwise have been entitled to under the agreement, because the defendant materially breached the agreement under Clause 8 (3), and the claimant did not violate the implied covenant of good faith and fair dealing in terminating the agreement. The tribunal observed that the claimant terminated the agreement under Clause 8 (1) due to the defendant's poor performance, but following the defendant's failure to remit the claimant's portion of the fee, the claimant notified the defendant that the defendant had committed a material breach under Clause 8 (3). In the tribunal's view, the claimant followed the procedure under the agreement when it notified the defendant of material breach. Moreover, the tribunal considered that the defendant's assertions were not supported by a preponderance of the evidence, and the claimant provided ample evidence that it initially terminated the agreement due to the defendant's poor performance, rather than in a bad faith effort to prevent the defendant from developing business.²⁶²⁷ Accordingly, the tribunal held that "[the claimant] followed the procedure under the Agreement when it notified [the defendant] of a material breach... [the defendant] failed to cure the breach within twenty-one days of notice from [the claimant]. As a result, [the defendant] forfeited its right to any pipeline deals that it otherwise would have been entitled to under the Agreement... Therefore, the arbitral tribunal concludes that [the defendant] is not entitled to any of the fees that were or may have been generated by the foregoing transactions according to the terms of Clause 9 (2) (1) of the Agreement." ²⁶²⁸

In principle, the parties are required to follow the process determined by the decision maker on the basis of the contract or the applicable default rules for its valid termination. In ICC Case No. 5948, the arbitral tribunal dealt with a number of issues regarding the termination by the employer of a contract which was governed by the law of the Employer's State, and based on the FIDIC conditions for Civil Engineering Works, Second Edition. The employer terminated the contract in reliance upon a certificate of the engineer under Clause 63, which

²⁶²⁶ Ibid., at 72

²⁶²⁷ Ibid., at 74

²⁶²⁸ Ibid., at 75

corresponds to Clause 15 of the 1999 Edition of the FIDIC Conditions.²⁶²⁹ The case concerned the construction contract between the Ministry of Public Works of an Arab state, as the employer, and an American contractor. The contractor was given notice referring to Clause 63 (1), and expelled from the site. The tribunal stated that Clause 63 is a “forfeiture clause and if it is to be relied upon, its machinery must be complied with strictly”.²⁶³⁰ Thus, the tribunal reasoned that “There can be no entry and expulsion under that clause ... unless in the first instance the Engineer has certified in writing to the [Employer] as far as is herein relevant that in his opinion the Contractor was not executing the Works in accordance with the Contract or was persistently or flagrantly neglecting to carry out his obligations. If and only if such certificate is addressed by the Engineer to the [Employer], the latter may give 14 days’ written notice to the Contractor enter upon the site, and expel the Contractor therefrom.”²⁶³¹ The tribunal held that the document relied upon by the employer as a certificate of the engineer under Clause 63(1) was not a certificate satisfying the requirements of that Clause because it was not addressed to the employer but to the contractor, it was “debatable” whether it was a communication from or an opinion of the engineer or the employer, and the document did not, in form, “certify” anything at all. Acknowledging that these were “very technical objections,” the tribunal emphasized that the Clause was a “forfeiture clause”, and in the context of interpreting a forfeiture clause, these objections were valid.²⁶³²

In view of the arguments of the employer that the contractor was not executing the works in accordance with the contract, or was persistently and flagrantly neglecting to carry out its obligations under the contract, the tribunal noted that “one would expect that under most systems of law, this would entitle the [Employer] to terminate the contract and expel the Contractor from the site.” The tribunal stated that “Nothing in Clause 63 of the Contract provides that the [Employer]’s right to exercise the option conferred upon it by that clause is to be the exclusive remedy for persistent and flagrant neglect on the part of the Contractor to carry out his obligations.” Thus, the tribunal examined the applicable rules of the chosen national law. The applicable law required a formal notice putting the non-performing party in default, and a judicial decision for the termination of the contract, in the absence of an agreement of the parties on the termination of contract by the operation of law. The tribunal found that there was no agreement under which the contract was to be brought to an end “automatically”, and no contractual provision that dispenses with the need for formal notice. The tribunal noted that there was no declaration in writing by the contractor that it was not willing to carry out its contractual obligations and, prior to the arbitration, the employer did not express an intention in the nature of a formal notice to terminate the contract, but on the contrary, by the various documents invoking Clause 63, the employer asserted that the contract was not terminated. The tribunal concluded that the necessary pre-requisites under the applicable law for a valid termination of the contract by the employer had not been established. Accordingly, the tribunal found the employer’s termination of the contract to have been wrongful.²⁶³³

²⁶²⁹ Seppälä, Christopher R., *International Construction Contract Disputes: Commentary on ICC Awards Dealing with the FIDIC International Conditions of Contract*, ICC International Court of Arbitration Bulletin, 9-2 (1998), at 43

²⁶³⁰ ICC Award in Case No. 5948, 1991, ICC International Court of Arbitration Bulletin, 9-1(1998), at 77

²⁶³¹ *Ibid.*, at 77-78

²⁶³² *Ibid.*, at 78

²⁶³³ *Ibid.*, at 79

In ICC Case No 10892, in order to build a sports stadium, a Caribbean state engaged the services of the Employer, a Caribbean company, which, in turn, entered into a construction contract with the Contractor, also a Caribbean company, which the Employer terminated on account of the Contractor's alleged default. The Contractor initiated arbitration proceedings, claiming the termination of the contract was wrongful, and sought damages. The construction contract incorporated the FIDIC Conditions Parts I and II, Fourth Edition. However, the Employer never filled in the name of the Engineer in Clause 1.1 of Part II of the FIDIC conditions, thereby leading to a dispute over the Engineer's identity. The tribunal found that, in these circumstances, the Engineer was the Employer itself, and the Contractor had tacitly accepted the Employer as the Engineer, because "a Contract governed by the FIDIC Conditions of Contract is unworkable without an Engineer".²⁶³⁴

The Employer purported to terminate the contract for the Contractor's failure to comply with the instructions of the Engineer under Clause 39.1 of the FIDIC Conditions, empowering the Engineer to issue instructions for removal from the site of any materials or Plant which, in the opinion of the Engineer, are not in accordance with the Contract. The tribunal found that, in the case, it was not the Engineer (Employer) who issued the certificate of failure by the Contractor to carry out instructions, which led to termination, but its delegate, B. According to the tribunal, "[B] was entitled to issue a certificate of non-performance by [Contractor] upon which [Employer] could rely to terminate the Contractor because [Contractor] impliedly accepted [Employer] as the Engineer and [B] as the Engineer's delegate (however grudgingly and however ambiguous the appointment) by continuing to work." The tribunal noted that Clause 63.1(e) of the FIDIC Conditions requires that "the Employer may, after giving 14 days' notice to the Contractor, enter upon the Site and the Works and terminate the employment of the Contractor..." The tribunal found that the Employer gave a 14-day notice of its intent to terminate the Contract, but it did not wait 14 days to enter the premises. The Employer obtained a court injunction, on the date of its notice, ejected the Contractor from the site the same day, and seized the Contractor's equipment and records for its use. The tribunal considered that the failure to wait 14 days to take possession was a violation by the Employer of Clause 63.1(e). The tribunal also stated that "In determining whether the termination was substantively proper, it must be kept in mind that [B] did not recommend termination and did not believe that the two items that were the subject of his ... instructions justified termination.... I do not find that the termination was proper."²⁶³⁵

When the terms of the contract or the applicable default rules do not include such safeguards against the termination of the contract as the mechanism of Nachfrist or right of the non-performing party to cure its deficient performance, the decision maker applying *lex mercatoria* should not imply into the contract those safeguards in a manner that invalidates the termination, unless the case falls under the narrow frames and requirements of those safeguards in accordance with the sources of abstractions. In ICC Case No 10422, the distributor argued that the termination was ineffective because, the manufacturer did not formally put the distributor into default ("mise en demeure") thereby giving it the chance to remedy its alleged non-performance and, in any case, notice of termination was not given timely. The arbitral tribunal considered that the position of the clamant would be justified if there were a contract term imposing a duty on the party giving notice of termination to grant

²⁶³⁴ ICC Final Award in Case No 10892 (March 2002), ICC International Court of Arbitration Bulletin, 19-2 (2008), at 91 et seq.

²⁶³⁵ Ibid.

the other party an additional period of time within which to remedy the alleged breach, as frequently happens in Anglo-American contract practice. The tribunal, referring to Article 7.3.2(1) of the UNIDROIT Principles, according to which the right to terminate the contract is exercised by notice without any further formality, rejected the claimant's argument that the defendant before terminating the agreement should have put the claimant formally into default. However, the arbitral tribunal also stated, by referring to Article 7.3.2 (2) of the UNIDROIT Principles, that the principle of good faith imposes on the party intending to terminate the contract on account of the other party's non-performance the duty to inform it of its intention within a reasonably short period of time from the moment when it came to know of the non-performance. The tribunal held that the manufacturer's notice of termination had not been given timely.²⁶³⁶

When a national law that governs the substance of the dispute contains such safeguards against termination, the decision maker applying *lex mercatoria* may consider primarily the reasonable expectations of the parties in determining the process of a valid termination of the contract, through the flexibility that is provided by the rules of interpretation of the parties' intentions and termination of contract under the applicable national law. In ICC Case No. 2114, the dispute arose from a licensing contract whereby Meiki, a Japanese corporation granted Bucher, a Swiss corporation, the exclusive right, license and privilege to manufacture certain specified plastics machines and Bucher agreed to manufacture Meiki's products "strictly in accordance with Meiki's designs and specifications". Meiki also granted Bucher the exclusive right to sell those products as manufactured by Bucher in various European countries, and Bucher was to pay Meiki a percentage of the net selling price of all of Meiki's products manufactured and sold by Bucher. However, Bucher did not manufacture Meiki's products under the terms of licensing contract on the ground that they were not well-suited for the European market and, instead, Bucher designed a new product, which was substantially different from Meiki's design. Bucher offered Meiki to pay the royalty only on the products designed according to Meiki's specifications. Meiki refused this offer and requested royalty over the entire price of machines sold. When Bucher refused to pay that royalty, Meiki terminated the licensing contract for material breach, as provided in the contract. The licensing contract did not contain a choice of law clause, and the arbitrator decided to apply Swiss law as the law of the country with which the contract had the closest territorial connection.²⁶³⁷

The arbitrator held that Bucher, by refusing to pay Meiki the full amount of the royalties, had breached the contract. The arbitrator based his reasoning on the principle of good faith under Article 2 (1) of the Swiss Civil Code, and stated that "Having made what could be considered as a poor business decision in entering into this licensing agreement with [Meiki] to manufacture the machines listed in [the agreement] on the ground that they could not be marketed in Europe at a profit, [Bucher] cannot then use part of [Meiki's] know-how and components in order to manufacture different models that would sell and then refuse to pay the royalties stipulated in the agreement". The arbitrator observed that "Prior to the signing of the licensing agreement, [Bucher] did not possess all the necessary know-how to manufacture [the relevant products]", and although many features of the products manufactured by Bucher was new, its progress could not have taken place without the knowledge of Meiki's technique.

²⁶³⁶ ICC Award No. 10422, 2001, Excerpts of the original French version of the award have been published in *Journal du droit international*, (2003), pp. 1142-1150 Available in English at <http://www.unilex.info/case.cfm?pid=2&do=case&id=957&step=FullText>

²⁶³⁷ ICC Award in Case No. 2114, 29 December 1972, *Yearbook Commercial Arbitration*, (1980), at 189

Thus, the arbitrator concluded that the defendant must pay the agreed upon royalty on the net selling price of the whole of these machines and not just proportionally to the parts or know-how used, on the ground that this must have been the intention of the parties, who must discharge their contractual obligation in good faith. According to the arbitrator, any other conclusion would destroy the principle of sanctity of contractual obligations freely entered into by the parties. The arbitrator considered that “when [Meiki] entered into the licensing agreement and provided the defendant with the necessary know-how, it did not expect that the defendant, by modifying the machines, would no longer have to pay the royalties due of [Meiki].”²⁶³⁸

Bucher argued that Meiki had not given proper notice of the termination of the contract, particular, in view of Article 107 of the Swiss Code of Obligations, which requires the party not receiving performance in due course to grant an additional time limit for performance and, upon failure of performance during that period, to express the intention not to accept the performance. The arbitrator observed that Meiki, on several occasions, requested that Bucher pay the royalty to which he was entitled, and Bucher refused. As Bucher merely proposed a new agreement, the arbitrator considered that no additional period for performance was necessary in view of Bucher’s attitude, according to Article 108 (1) of the Swiss Code of Obligations, which does not require the fixing of an additional period if the behavior of the obligor indicates that this would be in vain. Thus, the arbitrator held that the contract was validly terminated by Meiki and it could, in addition, recover the damages which resulted from the termination of the contract for material breach. The arbitrator awarded the damages to Meiki on the basis of the royalties on the machines sold by Bucher during the term of the contract.²⁶³⁹

Moreover, the decision maker applying *lex mercatoria* may reject a party’s argument that termination is invalid due to the terminating party’s failure to strictly follow termination process set out by the contract, depending on the seriousness of the circumstances that justify the termination of the contract. In ICC Case No 4629, the parties entered into a construction contract, whereby the claimants undertook an obligation to finish and furnish the defendant’s hotel. The contract provided for the application of Swiss law to the relationship between the parties. Given the difficulties with respect to timely fulfillment of the defendant’s financial obligations as well as its fulfillment of the technical matters, which were indispensable for the completion of the work, the claimants introduced a request for arbitration, asserting that they had been entitled to terminate the contract. The arbitral tribunal found that the claimants were certainly entitled to terminate the contract with compensation in view of the defendant’s failure to live up with its contractual obligations. However, the tribunal noted that the claimants did not follow exactly the procedure provided by the contract. According to the contract, the party entitled to terminate must, prior to termination, give notice to the defaulting party to fulfill its obligations within 30 days. The claimants suspended the work after a notice

²⁶³⁸ Ibid., at 190

²⁶³⁹ Ibid., at 191-192; It should be noted that, upon request of Meiki, the arbitrator also ordered Bucher, as of the date of the award, to cease the manufacture and sale of Meiki’s products listed in the contract, and not to use, disclose or sell Meiki’s know-how, which has not fallen in the public domain, since the arbitrator considered that those activities would constitute a case of unfair competition contrary to the Swiss Federal Law on Unfair Competition. However, this part of the award was set aside by the Swiss Supreme Court. Switzerland, Tribunal Federal, March 17, 1976, *Bucher-Guyer S.A. (Switzerland) vs. Meiki Co. Ltd. (Japan)*, *Yearbook Commercial Arbitration*, (1980), at 224

of ten days in December 1982 and, the contract was definitely terminated in February 1983. The contract did not rule expressly the event of suspension of the work.²⁶⁴⁰

The tribunal referred to the *exceptio non adimpleti contractus* under Article 82 of the Swiss Code of Obligations, which allows one party to withhold his performance of the contract as long as the other party does not fulfill or refuses to fulfill his part of the contract. According to the tribunal, the owner's obligation to place at the contractor's disposal the building in a condition permitting to work, to submit the necessary drawings and to obtain import licenses were of utmost importance, and the claimants were entitled by virtue of law to refuse to work until the owner had performed his own obligation. Moreover, the tribunal stressed that the claimants were entitled to terminate the contract already by December 1982, even though the contractual delay of 30 days had not yet elapsed, since the defendant made clear by its telex that he rejected the legitimate demands of the claimants. The tribunal referred to Article 108 of the Swiss Code of Obligations and to the practice of Swiss Federal Court that the expiration of time limit is not necessary when the defaulting party declares in advance that he will not perform. The tribunal stated that "being therefore entitled to terminate the contract without delay, claimants were a fortiori justified in suspending their work. The situation did not change during the first two months of 1983 and the claimants were still entitled to terminate the contract and to claim damages when they filed their request of arbitration."²⁶⁴¹

c. Effect of Termination

Under *lex mercatoria*, the rule that termination of contract does not preclude the aggrieved party from claiming damages can be considered as an established rule in the order of international commerce. The Iran US Claims Tribunal stated that "although the laws of various countries are not in full accord, the better view and the view adopted by this Chamber is that termination of the contract does not preclude a damage remedy."²⁶⁴² In ICC Case No 12193, the arbitral tribunal determined the law of Lebanon as the applicable law to a distribution contract between a German manufacturer, and a Lebanese distributor. The tribunal was of the opinion that *lex mercatoria* could be applied if Lebanese law provided no right to damages in the event of termination of the distribution, but this was not the case. The tribunal referred to Article 7.4.1 of the UNIDROIT Principles, as a general principle of law granting the right to damages for breach of contract, in order to demonstrate that the Lebanese law was in accordance with the *lex mercatoria*.²⁶⁴³ In the Italian Arbitration Association case cited above, the arbitral tribunal, applying Italian law, held that on account of the defendant's insufficient defence of the trademark, the claimant was entitled to terminate the exclusive distributorship contract. The tribunal considered awarding damages to the claimant for the early extinction of the contractual relationship, arising from termination of contract through the overriding fault of the defendant. The tribunal rejected the claim for an order of payment by the defendant of the costs borne by the claimant for the conduct of legal proceedings in the country of the original licensor since "the obligation breached by defendant was not that of initiating a legal action against the exporters in the country of the original licensor..., but rather the autonomous obligation of good faith arising in the performance of the contract, to

²⁶⁴⁰ ICC Award in Case No. 4629, 1989, Yearbook Commercial Arbitration, (1993), at 22

²⁶⁴¹ Ibid., at 23

²⁶⁴² Iran US Claims Tribunal Award in Case No. 255 (176-255-3) April 26, 1985, DIC of Delaware, Inc., Underhill of Delaware, Inc. v. Tehran Redevelopment Corp., The Government of the Islamic Republic of Iran, Yearbook Commercial Arbitration, (1986), at 338

²⁶⁴³ ICC Final Award in Case No. 12193, ICC International Court of Arbitration Bulletin, 19-1 (2008), at 122

afford proper co-operation and assistance to the suing claimant”. In the absence of a reliable criterion demonstrated by the party for the determination of the damages, the tribunal had recourse to the equitable criterion referred to in Article 1226 of the Italian Civil Code.²⁶⁴⁴

When the contract is validly terminated, the decision maker applying *lex mercatoria* should enforce the established rule in the order of international commerce that the contractual clauses, which are intended by the parties to operate after termination or to regulate the consequences of termination, survive the termination of the contract. In ICC Case No. 3267, the arbitrators considered the effect of termination, between the parties, on the bank guarantees furnished under the contract. The arbitrators interpreted the contract to the effect that there are two alternative methods to compensate the claimant for the consequences of a termination due to the defendant’s default. First remedy was a claim for damages for the items listed in the contract, including loss of expected profits, whereas the second allowed the claimant to exercise its rights under the Risk Exposure Bank Guarantee (REG), which actually led to the liquidation of damages on the basis of a pre-determined agreed figure. Given that the claimant’s request to exercise the second remedy, the arbitrators observed that second method of computing damages was of general use in construction contracts and there was “nothing unusual in resorting to liquidated damages in an international building contract drafted following the techniques and phraseology of the Common law world.”²⁶⁴⁵ The arbitrators noted that, under the REG, the parties agreed on an estimate of the amount of the investments not covered by the monthly payments and on the loss of profit arising from a cancellation of the contract at any time during the contract. Although, the amounts payable under the REG were very substantial, the arbitrators considered that this fact did not deprive the claimant from its right to call the entire amount thereof but, by claiming under the REG, the claimant waived its right to the outstanding amounts under the contract with the exception of unsettled claims, if any. The arbitrators held that “Whereas, in many legal systems, the amount of penalty would be reviewed by the Courts or by the arbitrators, the amounts of liquidated damages are not subject to such review. The Arbitral Tribunal adopts this view. It will not therefore review the amount agreed between the parties as liquidated damages.”²⁶⁴⁶

Since transactions governed through legal uncertainty will usually arise from long-term contractual relationships, the effects of termination will be prospective in most cases, where imposing a retrospective regime of mutual restitution may be inappropriate or impossible. In ICC Case No 9797, i.e. Andersen case, the ACBU member firms sought restitution of the transfer payments made to the AABU member firms, including the transfer payments placed in escrow, plus interest thereon upon termination. The tribunal noted that the performance of MFIFAs extended over a period of more than ten years, and the ACBU member firms, during that time, received several benefits from their association with the AABU member firms, e.g. the use of the Andersen name and client referrals by the AABU member firms. According to the tribunal, the restitution of the benefits received by the ACBU member firms was impossible, and if the tribunal were to grant the restitution of transfer payments made by the

²⁶⁴⁴ Italian Arbitration Association, Final Award in Case No. 76/98, November 24, 1999, *Yearbook Commercial Arbitration*, (2000), at 381

²⁶⁴⁵ ICC Award in Case No. 3267, 14 June 1978, *Yearbook Commercial Arbitration*, (1982), at 104

²⁶⁴⁶ *Ibid.*, at 104-105

ACBU member firms, they would be unjustly enriched. Thus, the tribunal did not grant the ACBU member firms the restitution they requested.²⁶⁴⁷

As to the other consequences of the termination, the tribunal held that the ACBU member firms must meet each and all of their obligations through and including the effective date of termination of their MFIFAs, namely July 28, 2000.²⁶⁴⁸ Moreover, the tribunal held that, effective on December 31, 2000, the ACBU member firms shall cease using the “Andersen” name or any derivative thereof, or any other name AWSC is authorized to regulate and shall cease to represent themselves as in any way associated with AWSC or the AABU member firms. The date of December 31, 2000 was fixed by the tribunal in order to allow the ACBU member firms a reasonable time frame to make the necessary changes and adjustments.²⁶⁴⁹

It is argued that the tribunal's decision with regard to the prohibition of the ACBU member firms from using the “Andersen” name, not with immediate effect as of the date of the award, but at a later date was surprising and could only find its justification in the light of Article 6.2.3(4) of the UNIDROIT Principles on the effects of hardship, which allows the tribunal to “if reasonable . . . terminate the contract at a date and on terms to be fixed”. Thus, it is suggested that perhaps the tribunal considered that, in addition to AWSC's breach, there was another reason for putting an end to the MFIFAs, namely the frustration of their purpose as a result of irreconcilable differences between the parties, which comes very close to hardship and therefore justified similar effects.²⁶⁵⁰ In the Andersen award, the reasoning of the tribunal applying *lex mercatoria* to the exclusion of any particular national law was naturally shaped by the submissions of the parties during the proceedings as well as the contextual interpretation of the MFIFAs, rather than the various and competing doctrines of termination for fundamental breach, termination for good cause or irreconcilable differences or hardship as provided by a national law or international restatements of contract principles. Thus, the Andersen award illustrates the primacy of the knowledge of particular circumstances of time and place over the pre-defined legal structures or formal consolidations, which incline the reasoning of the decision maker towards categorizations thereby rendering the accuracy in giving effect to the reasonable expectations of the parties a matter of secondary importance. Under *lex mercatoria*, non-consensual bases of legal considerations in the form of formal consolidations may yield to the interpretation of the contract and supplementation of it with individualized terms on the basis of the reasonable expectations of the parties in a particular case. However, the tribunal should have elaborated on its reasoning that allowed a transition period for the ACBU member firms, as to whether it was based on the interpretation of the contract or its supplementation with individualized terms, as he did with regard to the effect of termination on the “Andersen Technology”²⁶⁵¹, particularly in the presence of a specific

²⁶⁴⁷ ICC Award No. 9797, July 28, 2000, *Andersen Consulting Business Unit Member Firms vs. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative*, World Trade and Arbitration Materials, 12-5 (2000), at 212

²⁶⁴⁸ *Ibid.*, at 216

²⁶⁴⁹ *Ibid.*, at 220

²⁶⁵⁰ Bonell, Michael Joachim, A ‘Global’ arbitration decided on the basis of the UNIDROIT Principles: In re *Andersen Consulting Business Unit Member Firms v. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Société Coopérative*, *Arbitration International* 17 (2001), at 260

²⁶⁵¹ In this regard, the arbitrator referred to general principles of law, particularly Article 4.1 (1) and (2) of the UNIDROIT Principles as well as to the corresponding provisions of the PECL. ICC Award No. 9797, July 28, 2000, *Andersen Consulting Business Unit Member Firms vs. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative*, World Trade and Arbitration Materials, 12-5 (2000), at 223-224; See Chapter 4, b, ii

provision in the MFIFAs “for the event of termination, whereupon no member firm or any of its individual partners may use the Andersen name or any of its derivatives or represent itself to be associated with AWSC or the member firms without the written permission of AWSC.”²⁶⁵²

The significance and primacy of the knowledge of particular circumstances of time and place should also be upheld in cases, where the decision maker applying *lex mercatoria* may be required to consider restitutionary remedies in a particular case. In such cases, the decision maker should utilize the restitutionary flexibility under the default rules applicable to the contract with regard to retrospective effect of termination, within the context of competing interests of the parties, as a means of achieving justice in a particular case. In its considerations, the decision maker should keep in mind any restitutionary intervention as a result of termination of the contract must be sensitive to the particular circumstances of the case. The focus should be on whether or not a particular transfer is regulated by the contract, whether there is a binding allocation of risk ascertained through interpretation, and whether it is possible to identify an implicit allocation of risk through supplementation, for an accurate reflection of the reasonable expectations of the parties to the particular contract. If the decision maker is unable to find an accurate solution to the problem of restitution on the basis of these considerations, it may invite the parties to settle their differences by providing guidelines in a partial award for the parties to facilitate such a settlement, and once the parties fail to settle, the decision maker may render a final award by utilizing the increased knowledge of the particular circumstance of time and place that can be derived from the parties’ discussions during the failed attempt of settlement.

In ICC Case No. 8782, the claimant, a Belgian company, ordered an automated fish-sorting machine from the defendant, a Danish manufacturer. The contract incorporated the General Conditions for the Supply and Execution of Plant and Machinery for Import and Export No. 188 A of March 1957 of United Nations Economic Commission for Europe (UNECE Conditions), and it was governed by Danish law. The defendant was not able to meet the delivery date and the parties agreed to two amendments to the contract, according to which, the machine was scheduled for delivery in two phases, and the total price was adjusted. The machine did not perform properly in either of these phases and the claimant initiated arbitration claiming that it was entitled to cancel the contract for the defendant’s fundamental breach, to return the machine and to be refunded the amount paid for the machine. The defendant argued that although the claimant knew that the machine was a new concept and riddled with serious problems right from the beginning, it actually accepted delivery of the machine, and thus, it was barred from cancelling the contract.²⁶⁵³

The sole arbitrator observed that the defendant, with its technical background and expertise, was in a better position than the claimant to judge if this concept could be successful. Thus, in the arbitrator’s opinion, it would have been prudent for the defendant to make more reservations in the contract on the chance of success or failure than it actually did, and in the absence of such reservations, the defendant assumed the risk of failure of the machine. The contract did not contain any explicit provision with regard to cancellation, termination or dissolution of the contract. Considering that the principles of Danish law either incorporate the relevant provisions of the CISG or they are essentially same as these provisions, the arbitrator applied the CISG to the issue. Applying Article 25 of the CISG, the arbitrator found

²⁶⁵² Ibid. at, 218; Paragraph 18.1 of the MFIFAs

²⁶⁵³ ICC Award in Case No. 8782, 1997, Yearbook Commercial Arbitration, (2003), at 44

that the machine, as delivered and installed, did not perform on essential points as the claimant could reasonably expect under the contract, the claimant can be considered to be substantially deprived of what it was entitled to expect under the contract, and the defendant foresaw such detrimental results. Thus, the arbitrator held that the claimant's request for a ruling that its notification of cancellation of the contract was rightful and should be awarded.²⁶⁵⁴

Then, the arbitrator considered whether the cancellation of the contract should have a retrospective effect, as requested by the claimant, thereby requiring the return of the contract price and the machine. In this respect, the arbitrator considered the residual allocation of contractual risks. In the arbitrator's opinion, although the risk of contracting for and delivering the machine was in principle more for defendant than for the claimant, the claimant also took a serious risk that the machine might not work in accordance with the terms of the contract when the defendant made clear that it might not be able to deliver a machine in accordance with the contract and raised the issue of cancellation of the contract before the signing of the amendments. Thus, the arbitrator questioned "if the claimant could – and should – not have mitigated its damages by relieving the defendant from its obligation to deliver the machine in accordance with the terms of the Contract."²⁶⁵⁵ The arbitrator stated that "in general, there is an obligation for a creditor who is suffering damages or is confronted with the possibility that he might suffer damages to limit or prevent same." Moreover, the arbitrator reasoned that "if it is true that the defendant, at the time when it delivered the machine, could foresee its detrimental results, the same is true for the claimant." Although it was not clear either or to what extent these considerations could be invoked under Danish law, the arbitrator sought a basis for those in Clause 26 (1) of the UNECE Conditions and Article 74 of the CISG, both of which provide that the amount of damages that can be recovered by the aggrieved party may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, and Clause 26 (2) of the UNECE Conditions, which contained the aggrieved party's duty to mitigate, and Article 76 of the CISG, which sets forth an alternative means of determining damages on the basis of market price in cases where the contract was avoided but the aggrieved party did not resell the goods in question or, did not purchase any goods in replacement in a reasonable manner and within a reasonable time after avoidance.²⁶⁵⁶

In view of these applicable provisions, the arbitrator stated that he was under the impression that claimant could have limited damages which it allegedly suffered if it had cooperated in terminating the contract before taking final factual delivery of the machine. However, the arbitrator, having determined the contract had been rightfully terminated, concluded with a partial award inviting the parties to settle the remaining issues, such as whether the machine was to be replaced by a new system or if the machine would be used despite its defects, and the quantum of damages, taking into account the considerations as laid down in the award, and to report to the arbitrator about the status of their discussions.²⁶⁵⁷ Thus, the arbitrator considered the competing interests of the parties to a contract for the turnkey supply of an industrial machine. In the particular circumstances of the case where the parties residually shared the risk of failure of the machine, the arbitrator was not able to strike a balance

²⁶⁵⁴ Ibid., at 48

²⁶⁵⁵ Ibid., at 49

²⁶⁵⁶ Ibid., at 50

²⁶⁵⁷ Ibid., at 53

between the harsh consequences for the supplier resulting from dismantling of the machine and returning the contract price, and the reasonable expectations of the purchaser from the machine in achieving its purpose, and deferred rendering a final decision until the parties fail to settle the remaining issues.

3. Concluding Remarks

The parties' right to terminate the contract under *lex mercatoria* requires the decision maker to focus on the contract and the default rules chosen by the parties pursuant to the basic principles of freedom of contract and *pacta sunt servanda*. To the extent there are gaps or standards in the articulated rules in relation to the specific issues of termination raised in the proceedings, the abstract reasoning of the decision maker should be motivated by the consideration that certain circumstances, whether it is non-performance of express or implied obligations, or another unforeseen or foreseen event, may justify the exercise of the right to terminate the contract by a party, and affect the process of termination set out by the articulated rules, to the extent such a party cannot be reasonably expected to continue with the contractual relationship under such circumstances.

The decision maker applying *lex mercatoria* should determine through a contextual approach whether the particular circumstances have attained a sufficient degree of seriousness so as to enable a party to leave the bond of *pacta sunt servanda*, by considering the risk allocation agreed by the parties, submissions of the parties during the proceedings, their interests in continuing or ending the contractual relationship, the other circumstances surrounding the contract, nature and purpose of the contract as well as the articulated rules in a particular dispute. Under the transactions governed through legal uncertainty, the decisive factor in determining whether a particular circumstance justifies the termination by a party will be the extent of its detrimental effect on that party's reasonable expectations from the contractual relationship and from the future performance of contractual obligations.

Upon the occurrence of such circumstances that justify the termination of the contract, the entitled party should exercise its right to terminate by giving notice to the other party within a reasonable period of time, in accordance with the established rule in the order of international commerce, unless the parties leave the matter entirely to the default rules of their choice, which require a judicial decision for the termination of the contract. The requirement of termination notice mitigates the negative consequences of termination for the other party preparing his performance in the context of international contracts. When it is necessary to enable transition, the decision maker should also consider allowing for a sufficient notice period in the particular circumstances of the case. However, the incorporation into the process of termination of such safeguards as the mechanism of *Nachfrist* or right of the non-performing party to cure its deficient performance depends on the articulated rules, the applicable default rules pursuant to the established rules of conflict, or the *ex post* supplementation of the contract by the decision maker with individualized terms within the narrow frames and requirements of those safeguards in accordance with the sources of abstractions. The degree of seriousness of the circumstances that justify the termination of the contract is also relevant to the determination of to what extent the party exercising its right to terminate the contract should follow the process of termination set out by the terms of the contract or the applicable default rules.

Under *lex mercatoria*, the termination of the contract has mainly a prospective effect, discharging the parties from their obligations of future performance, since transactions

governed through legal uncertainty will usually arise from long-term contractual relationships, where imposing a retrospective regime of mutual restitution may be inappropriate or impossible. It is an established rule in the order of international commerce that the termination of contract does not preclude the aggrieved party from claiming damages for non-performance, or from invoking such contractual clauses that are intended to operate even after termination, unless termination has resulted from a gap in the risk allocation with regard to such unforeseen events that excused the non-performance. In cases where the decision maker is required to give effect to the retrospective effect of termination, such as contracts for the turnkey supply of an industrial plant, the decision maker should examine the restitutionary consequences of termination within the context of the competing interests of the parties, and contractual risk allocations, which are to be determined and ascertained through interpretation or supplementation, to the extent that the decision maker is enabled to exercise its abstract reasoning on the basis of these considerations by the flexibility of the default rules that are applicable to the substance of the dispute, pursuant to the choice of the parties or the established rules of conflict.

vi. Damages for non-performance

Under *lex mercatoria*, when the liability for the non-performance of a specific or residual contractual obligation is established and it is not excused due to unforeseen contingencies, the aggrieved party may resort to the remedy of damages as a substitutionary relief. The aggrieved party, either in conjunction with or as an alternative to its right to terminate the contract, may claim the relief of damages. It is a form of compensation for not having received the proper performance of contractual obligation. The conventional analysis of contract law is based on the principle that the purpose of damages is to compensate the victim of non-performance for his injury.²⁶⁵⁸ This principle limits the extent of recoverable damages in various ways. First, damages are based on loss to the aggrieved party and not on the gain to the non-performing party. Secondly, the aggrieved party cannot recover more than his loss. Thirdly, damages for non-performance of contract are compensatory, so “punitive” (or “exemplary”) damages will not be awarded for breach of contract.²⁶⁵⁹ The fourth limitation is that no damages are recoverable if the aggrieved party has suffered no loss.²⁶⁶⁰

Although these basic considerations are common across most national legal systems, the rules regarding the assessment of damages leave much to the decision maker’s discretion, since it is very difficult to establish *ex ante*, namely before the actual non-performance, the kind of situation that will emerge after it is committed. The remedy of damages requires an *ex post* perspective since it deals with such situations that arise after an obligation has been breached. Thus, the default rules on damages under the national legal systems must account for the practical way of correcting the wrong or otherwise restoring the balance between the parties in the particular circumstances of the case.²⁶⁶¹

Particularly in the presence of complex, innovative or long-term contractual relationships, it is difficult for the party to appraise *ex ante* the extent of his liability in damages for non-performance, unless some aspects of that remedy are regulated by the contract, through contractual clauses that limit or stipulate beforehand the recoverable amount of damages for non-performance, such as exemption or limitation of liability clauses, or penalty or liquidated damages clauses, to the extent allowed by the freedom of contract. In this context, the remedy of damages is an issue, in which the decision maker in almost any judicial setting is allowed to resort to equity *infra legem* in the assessment of damages, for which most of the national

²⁶⁵⁸ Cooter, Robert and Melvin A. Eisenberg, *Damages for Breach of Contract*, *California Law Review*, 73-5 (Oct., 1985), at 1434

²⁶⁵⁹ Such damages may be awarded in tort cases, not to compensate the plaintiff but to indicate the court’s disapproval for the conduct of the defendant. Treitel, G.H., *Remedies for Breach of Contract* (Courses of Action Open to a Party Aggrieved), *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 25; Restatement (Second) of Contracts, Section 355 provides that “Punitive damages are not recoverable for a breach of contract unless the conduct constituting the breach is also a tort for which punitive damages are recoverable.”

²⁶⁶⁰ There appears to be an exception in the common law countries, which allow “nominal damages” consisting of a trivial sum awarded to indicate that the contract has been broken, even though the breach has caused no loss. In common law, the courts used the concept of nominal damages in order to evade the rule that they could not make purely declaratory judgments. The effect an award of nominal damages is a declaration of rights rather than an award of compensation in money for the breach of contract, and the power to make such an award is not in substance inconsistent with the principle that damages are compensatory. Treitel, G.H., *Remedies for Breach of Contract* (Courses of Action Open to a Party Aggrieved), *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 26

²⁶⁶¹ Friedmann, Daniel, *Rights and Remedies*, in Nili Cohen & Ewan McKendrick (eds.), *Comparative Remedies for Breach of Contract*, Oxford: Hart, 2005, at 14-15

legal systems recognize a margin of discretionary power. Thus, the abstract reasoning of the decision maker plays a decisive role in the issue of damages for non-performance under *lex mercatoria*.

1. Sources of Abstractions

a. National Laws

Article 1149 of the French Civil Code provides that, subject to exceptions and modifications, the damages due to the creditor consist of two elements: the loss, which he has suffered, and the gain, which he has failed to make. These elements refer to the civil law distinction between *damnum emergens* (actual loss) and *lucrum cessans* (lost gain). French law appears not to make a distinction between the expectation loss and reliance loss, i.e. between the loss of benefits which would have accrued to the creditor if the contract had been performed and the loss incurred by the creditor in reliance on the debtor's promise to perform.²⁶⁶² There are three main limitations that determine the extent of the loss for which damages will be awarded under French law.

Firstly, Article 1150 provides that debtor is only liable for such damages as he could have foreseen at the time of contracting. This first limitation is based on the premise that the parties can reasonably be expected to have entered into the agreement on the basis of foreseeable risks.²⁶⁶³ Under the foreseeability test, the debtor is held liable for loss, which a reasonable person could have foreseen. The limitation does not apply where the default in performance is due to the “*dol*” (fraud) of the debtor.²⁶⁶⁴ “Fraud” in this context means a deliberate breach of contract or one committed in bad faith, and it is generally agreed that fraud also includes gross negligence.²⁶⁶⁵ The second limitation is provided under Article 1151 of the French Civil Code. The damage must be an “immediate and direct consequence” of the non-performance of the contract. The limitation of liability to “direct” damage is distinct from that of foreseeable damage. Even a debtor who is guilty of “fraud” and liable for unforeseeable damage is not liable for “indirect” damage. Where the debtor is not guilty of fraud, the requirements of foreseeability and directness must both be satisfied, and “directness” imports a requirement of causation.²⁶⁶⁶ Thirdly, there is no right of recovery in respect of hypothetical future damages.²⁶⁶⁷ The damages must be certain, but this limitation is applied flexibly and future damages are awarded if they are reasonably capable of being calculated by the court upon an estimate of their probability.²⁶⁶⁸

²⁶⁶² Bell, John, Sophie Boyron & Simon Whittaker, *Principles of French law*, Oxford University Press, 2nd ed., 2008, at 353

²⁶⁶³ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 229

²⁶⁶⁴ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1004

²⁶⁶⁵ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 57

²⁶⁶⁶ *Ibid.*, at 59-60

²⁶⁶⁷ *Ibid.*, at 83

²⁶⁶⁸ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 228

Under French law, the assessment of damages will be made by the court exercising its power of discretion under the basic principle that damages should compensate the creditor for the loss suffered.²⁶⁶⁹ The Cour de Cassation in principle still controls the question of the character of loss for which the damages should be awarded, and requires the lower courts to formulate their judgments in such a way to enable that control.²⁶⁷⁰ The French Civil Code does not lay down a specific time for the assessment. It is argued that the general principle is that damages are to be evaluated at the time of judgment, except where this will result in awarding the creditor more than compensation.²⁶⁷¹ Under Article 1146 of the French Civil Code, damages begin to run only from the moment at which the debtor is “put in delay” (“mise en demeure”). The initiation of a court action constitutes a mise en demeure, but the debtor is liable only for damage occurring after that moment.²⁶⁷² Mise en demeure is not required where the nature of obligation is such that it can only be performed at a certain time and that time elapsed, or where it would serve no purpose, such as when the debtor expressly refused to perform. Moreover, the requirement of mise en demeure is generally limited by both courts and the doctrine to claims for damages for delay.²⁶⁷³ Pursuant to Article 1339 of the French Civil Code, the parties may agree to dispense with the requirement of mise en demeure, and this agreement may be implicit.²⁶⁷⁴

In French law, if there is a market price for the substitute at the relevant time, the court may base its award on market price, in assessment of damages. The assessment of damages can also be based on the actual cost incurred by the creditor in procuring a substitute contract. Article 1144 of the French Civil Code provides that the creditor may be authorized to perform himself at the expense of the debtor. Thus, the creditor requires the authority of the court before proceeding with a substitute contract, and the court may in its discretion refuse to authorize him to do this.²⁶⁷⁵ Once the authorization is obtained, the debtor may be ordered to pay for the substitute performance in advance, thereby relieving the creditor of the risk of failing to recover its cost. French law recognizes exceptions to the requirement of judicial authorization for substitute performance, particularly, in the commercial sales of goods and in cases of urgency where the immediate nature of the creditor’s need for a substitute performance overrides the debtor’s right to perform.²⁶⁷⁶

²⁶⁶⁹ Ibid., at 231

²⁶⁷⁰ Ibid., at 225

²⁶⁷¹ Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 49; Nicholas, Barry, The French law of contract, Oxford University Press, 1992, at 231

²⁶⁷² Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, Contract Law (Ius Commune Casebooks for the Common Law of Europe): 5, Hart Publishing; 2nd Revised edition, 2010, at 1000

²⁶⁷³ Bell, John, Sophie Boyron & Simon Whittaker, Principles of French law, Oxford University Press, 2nd ed., 2008, at 353

²⁶⁷⁴ Nicholas, Barry, The French law of contract, Oxford University Press, 1992, at 236-240

²⁶⁷⁵ Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 46

²⁶⁷⁶ Whittaker, Simon, Contributory Fault and Mitigation; Rights and Reasonableness: Comparisons between English and French Law, in L. Tich (ed.), Causation in Law, Univerzita Karlova v Praze, 2007, (at 18 on the file with author)

Under French law, there is no duty to mitigate the loss for the aggrieved party. In principle, an award of damages must accord full compensation in respect of all of losses of the aggrieved party, subject to certain requirements. The scope of specific performance is extensive and, according to the French Civil Code, the substitute transaction is only an optional possibility that the creditor must, in principle, request before the court. Thus, it is argued that the court may not dismiss a claim for specific performance on the sole ground that the creditor had the possibility, and therefore, the duty to find a substitute for himself, and that the introduction of the principle of mitigation in French contract law would restrict the right to specific performance where a substitute transaction on a market is reasonably feasible.²⁶⁷⁷ However, courts developed other techniques serving the similar purposes. A French court invoked the doctrines of remoteness and foreseeability in holding that a trader, who had been supplied with defective products in breach of contract, should have limited the loss flowing from the breach by finding an alternative intermediate solution, and considered any damage resulting from his failure as unforeseeable by the parties at the time of contracting and, thus, irrecoverable.²⁶⁷⁸ In another case, it was held that a creditor, who fails to warn the debtor that the contract is breached and allows damages to mount up, will not recover additional loss, which will be treated as his own fault.²⁶⁷⁹ It is also argued that the French courts could rely on the principle of good faith under Article 1134 of the Civil Code, requiring the parties to co-operate with each other even after non-performance.²⁶⁸⁰

There is no provision in the French Civil Code, which provides for a doctrine of contributory negligence in the cases of breach of contract. Even so, the courts referred to the need for a causal link between the loss and non-performance in dealing with the relevant questions. If the loss is due to the act or fault of the victim, the liability of the defendant may be extinguished or attenuated. It is extinguished if the act of the victim can be said to be the sole cause of the loss, and attenuated if the fault of both parties has contributed to the loss.²⁶⁸¹ Thus, the courts, on the basis of their discretionary power, may reduce an aggrieved party's damages on the ground of his contributory fault ("faute de la victim"), regardless of the

²⁶⁷⁷ Laithier, Yves-Marie, Comparative Reflections on the French Law of Remedies for Breach of Contract, in Nili Cohen & Ewan McKendrick, *Comparative Remedies for Breach Of Contract*, Oxford: Hart, 2005, at 115-116

²⁶⁷⁸ Court of Appeal of Versailles (26 Nov 1986) *Gaz Pal* 1987, 2, somm 402. Cited by Le Pautremat, Solène, Mitigation of Damages: A French Perspective, *International and Comparative Law Quarterly*, 55-1 (Jan., 2006), at 207

²⁶⁷⁹ Cass. Civ (1), 29 April 1981, JCP.1982.II.19730, cited by Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1019

²⁶⁸⁰ Whittaker, Simon, Contributory Fault and Mitigation; Rights and Reasonableness: Comparisons between English and French Law, in L. Tich (ed.), *Causation in Law, Univerzita Karlova v Praze*, 2007, (at 11 on the file with author); The Paris Court of Appeal invoked the principle of good faith to perform a similar function to mitigation. In the case, the claimant declined to exercise a contractual option to serve a break notice which would have terminated his contract with the debtor, even though the debtor was already in significant arrears under the agreement. The claim in respect of debts accruing thereafter was dismissed. To allow the contract to continue in such circumstances was held to be an act of bad faith which effectively aggravated the claimant's own loss. Court of Appeal of Paris (22 June 2001) D 2002, 843, cited by Le Pautremat, Solène, Mitigation of Damages: A French Perspective, *International and Comparative Law Quarterly*, 55-1 (Jan., 2006), at 207

²⁶⁸¹ Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tubingen: Mohr, 1976, at 82

content of the obligation on the breach of which he relies, whether de résultat or de moyens.²⁶⁸²

Under French law, it is in principle open to the parties to specify in advance the amount of damages for non-performance. Article 1152 of the Civil Code provides that when an agreement provides for the payment of a certain sum by way of damages in case of non-performance by one party, i.e. penalty clauses, the other may not be awarded either a larger or a smaller sum. However, if the debtor is guilty of fraud or gross negligence, the creditor may claim full damages and is not limited to the amount agreed in the penalty clause.²⁶⁸³ The original provision excluded any power in the court to review the stipulated sum under the penalty clause.²⁶⁸⁴ In order to prevent possible abuses, the law was amended to give the courts the power to control the stipulated sum. A second paragraph was added to Article 1152, providing that the courts can, of their own motion or otherwise, diminish or increase the agreed penalty if it is manifestly excessive or derisory, and any provision in the contract to the contrary shall be deemed not to have been made. In exercising this discretionary power, the court must indicate in what respect the agreed amount is excessive or derisory, it must observe the requirement that discrepancy must be manifest, and it may not reduce the amount below the level of the actual damages.²⁶⁸⁵ Moreover, Article 1231 of the Civil Code provides that when the obligation has been performed in part, the court can, of its own motion or otherwise, reduce the agreed penalty in proportion to the advantage which the part performance has given to the creditor, and any provision to the contrary shall be deemed not to have been made.

Thus, under French law, the parties may agree on an upper limit for the amount of damages recoverable for non-performance.²⁶⁸⁶ In this sense, the penalty clauses may serve the purpose of limiting the debtor's liability and act as a limitation of liability clause in some cases. However, the court may strike down if such limits are considered derisory. Moreover, even if the debtor benefits from such a penalty clause, the restrictions with regard to the limitation or exclusion of liability clauses under French law will be applicable. Accordingly, the clauses excluding one party's liability for the non-performance or fixing an upper limit for his liability are held to be valid except in so far as the party invoking it is guilty of fraud or gross negligence. Thus, if the debtor is guilty of fraud or gross negligence, the creditor may claim full damages and is not limited to the amount in the penalty clause.²⁶⁸⁷

Section 280 of the German Civil Code contains the main provision concerning damages for non-performance. It provides that if the debtor fails to comply with a duty arising under the contract, the creditor is entitled to claim compensation for the loss caused by such breach of

²⁶⁸² Bell, John, Sophie Boyron & Simon Whittaker, *Principles of French law*, Oxford University Press, 2nd ed., 2008, at 354

²⁶⁸³ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1052

²⁶⁸⁴ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 97

²⁶⁸⁵ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 236

²⁶⁸⁶ *Ibid.*, at 232

²⁶⁸⁷ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1052

his duty. The claim for damages is based on the notion of fault, but fault is not, strictly speaking, a requirement for the claim, since it is the debtor who has to prove that he was not responsible for the breach of duty. Pursuant to Section 276 (1), the debtor is not only responsible for fault in the sense of deliberate and negligent acts or omissions, but may also be subject to a stricter or more lenient degree of liability if it is specified or to be inferred from the other subject matter of the obligation, in particular the assumption of a guarantee or the acquisition risk.²⁶⁸⁸ Section 276 (3) provides that the parties cannot agree in advance to relieve the obligor of liability for deliberate acts or omissions.

The German Civil Code distinguishes between damages in lieu of performance and damages for delay. Damages in lieu of performance can be claimed only if the additional requirements of Sections 281, 282 or 283 of the Civil Code are met. The claim for damages in lieu of performance substitutes the performance. Thus, after receiving the damages the aggrieved party should be in the same financial position as it would have been had the contract been performed exactly in the way promised.²⁶⁸⁹ Pursuant to Section 281 (1), if the debtor does not perform, or does not perform properly, at the time when he has to perform, the creditor may claim damages in lieu of performance provided that he has fixed, without success, a reasonable period for effecting performance or remedying the defective performance. Moreover, if the debtor has performed only in part, the creditor may demand damages in lieu of performance only if he has no interest in performance in part. When the obligor has failed to perform properly, the obligee may not demand compensation in lieu of performance if the breach of duty is immaterial. Section 281 (2) dispenses with the requirement of fixing a period for performance if the debtor seriously and definitely refuses to perform or if there are special circumstances which, after each party's interests are balanced, justify the immediate assertion of a claim for damages. Under Section 282, infringement of one of ancillary duties leads to a claim for damages in lieu of performance if the creditor can no longer reasonably be expected to receive performance. Section 283 enables the creditor to claim damages in lieu of performance in all cases of subsequent impossibility unless the debtor proves that he was not responsible for the impossibility to perform.²⁶⁹⁰ Thus, the position of German law with regard to the damages in lieu of performance corresponds to a great extent with the case of the right to terminate. The claim damages in lieu performance require a non-excused material non-performance and a Nachfrist mechanism subject to certain exceptions.

The detriments caused to the creditor until performance finally rendered may be compensated by a claim of damages for delay.²⁶⁹¹ The damages for delay leave the debtor's duty to render performance unaffected, and cover the loss that has arisen because the debtor has not performed in time. It includes gains lost or expenses incurred as a result of the delay as well as decline in value of the subject-matter during the period of delay. For the claim of damages for delay, Section 286 of the German Civil Code requires the creditor to serve a special warning ("Mahnung") on the debtor, who has not performed after performance became due.

²⁶⁸⁸ Zimmermann, Reinhard, *Breach of Contract and Remedies Under the New German Law of Obligations*, Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari 48, Rome, 2002, at 17-18

²⁶⁸⁹ Coester-Waltjen, Dagmar, *The New Approach to Breach of Contract in German Law*, in Nili Cohen & Ewan McKendrick (eds.), *Comparative Remedies For Breach of Contract*, Oxford: Hart, 2005, at 145-146

²⁶⁹⁰ Zimmermann, Reinhard, *Breach of Contract and Remedies Under the New German Law of Obligations*, Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari 48, Rome, 2002, at 20

²⁶⁹¹ Coester-Waltjen, Dagmar, *The New Approach to Breach of Contract in German Law*, in Nili Cohen & Ewan McKendrick (eds.), *Comparative Remedies For Breach of Contract*, Oxford: Hart, 2005, at 150

Under Section 286 (2), *mahnung* is not necessary, where a time for performance is fixed, the debtor seriously and definitely refuses to perform, or special reasons justify the occurrence of default with immediate effect. Finally, Section 280 (1) itself applies to the cases other than designated as those of damages in lieu of performance and damages for delay. It covers consequential loss, i.e. damage suffered by the creditor as a result of the breach of contract, with respect to other objects of legal protection.²⁶⁹² In this case, the claim for damages does not substitute the original claim for performance, but exists beside the latter.

The extent of damages available under German law is generally addressed in the general part of the law of obligations, which apply to all damage claims, whether they arise from tort, contract, or another source. Pursuant to Section 249 of the Civil Code, the basic principle in German law of damages is *restitutio ad integrum*, in the sense that a person who is liable in damages must restore the situation which would have existed if the circumstance rendering him liable to pay damages had not occurred. Thus, under German law, in principle, every pecuniary loss caused by non-performance of the contract may be recovered. This is called positive interest.²⁶⁹³ Under Section 284 of the Civil Code, instead of claiming damages in lieu of performance, the creditor may recover any expenses that he has incurred in the expectation of receiving performance and that he was reasonably entitled to incur, unless the purpose of these expenses would have been frustrated even without the debtor's breach of duty. This is called negative interest and usually preferred by the creditor, if he finds it difficult to quantify his loss or to establish any loss at all.²⁶⁹⁴

Under German law, the damages are not limited to losses which the non-performing party had or could have reasonably foreseen. Instead of foreseeability, the principle of adequate causation applies. The questions of causal connection depend to a great extent on the discretion of the judge. Even so, there are certain general principles which the judge is bound to observe. The theory of "adequate causation" holds that a wrongdoer is liable for a loss if his default appreciably increased the objective possibility of a loss that in fact occurred. On the other hand, the wrongdoer is under no liability if his default was, according to the ordinary course of things, quite indifferent with regard to the consequence which in fact occurred, and only became a condition of the occurrence of the loss as a result of unusual or intervening events.²⁶⁹⁵ The adequacy of causation is judged from the perspective of objective or optimal observer, having knowledge of all the circumstances of which a person of that kind could have known, as well as any additional circumstances of which the wrongdoer himself actually knew. Moreover, the loss for which compensation is sought must be within the protective purpose of the contract. This requires a determination of whether the duty which was breached was supposed to protect the creditor from the type of harm, which in fact resulted. The approach of protective purpose of the contract is usually seen as limiting the recoverable harm to a greater extent than the theory of adequate causation, since the debtor's non-performance may have increased the probability that harm of the relevant type would occur,

²⁶⁹² Zimmermann, Reinhard, *Breach of Contract and Remedies Under the New German Law of Obligations*, Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari 48, Rome, 2002, at 26-27

²⁶⁹³ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 995

²⁶⁹⁴ Zimmermann, Reinhard, *Breach of Contract and Remedies Under the New German Law of Obligations*, Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari 48, Rome, 2002, at 28

²⁶⁹⁵ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 66

but such loss may still be held to be outside the purpose of the contractual norm. The precise scope of the protective purpose of the contract is a matter of fact to be determined in the light of all the circumstances, including the intentions of the parties.²⁶⁹⁶

Section 254 of the German Civil Code incorporates the doctrines of contributory negligence and mitigation of loss. It provides that if the fault of the aggrieved party contributed to his loss, the existence and extent of the damages depends on the circumstances and in particular on the question how far the loss was preponderantly caused by, or was due to the fault of, one or the other of the parties. This principle is expressly stated to apply to two special situations under Section 254 (2): where the fault of the aggrieved party is limited to failure to warn the other party of the risk of an exceptionally high loss; and where the injured party has omitted to take steps to avoid or reduce the loss. This provision was in fact added in the place of a draft foreseeability rule, which provided that the liability for failure to perform of the person owing performance does not extend to compensation for harm the occurrence of which lay beyond the realm of probability given the awareness of circumstances which that person had or should have had.²⁶⁹⁷ The draft rule was deleted for being too restrictive, but Section 254 (2) has been used by the courts in the same manner that some French courts have used the foreseeability rule.²⁶⁹⁸

Lost profits are recoverable under Section 252 of the German Civil Code, which provides that a profit will be deemed to have been lost if it is one which would have been expected as probable to be made in the ordinary course of things or in the special circumstances, having regard to preparations and provisions made by the aggrieved party.²⁶⁹⁹ It will generally suffice for the aggrieved party to show that the circumstances envisaged by Section 252 exist. However, under the test of adequate causation, the defaulting party could still limit his liability by showing that the default did not appreciably increase the objective possibility of loss of a kind that in fact occurred.²⁷⁰⁰

Under German law, there are two main theories for calculating the amount of damages in reciprocal contracts. First, according to the “exchange theory”, the creditor is entitled to the whole value of the debtor’s performance including lost profit, but only on condition of performing his own promise. The second theory is the “difference theory” whereby the creditor is on account of debtor’s non-performance is released from his obligation to perform his own promise, and he is entitled to claim the difference in value between the performance which was promised to him and that which was promised by him, but only if he has not yet rendered performance and wishes to retain it. The German courts have a general tendency to apply the difference theory due to the commercially inconvenient results arising from the exchange theory. There are also cases in which the difference theory would produce inconvenient results, and in these cases, the theory is not followed. For instance, where the

²⁶⁹⁶ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1013-1014

²⁶⁹⁷ Gordley, James, *The Foreseeability Limitation on Liability in Contract*, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, C.E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 222

²⁶⁹⁸ *Ibid.*

²⁶⁹⁹ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 83

²⁷⁰⁰ *Ibid.*, at 67

aggrieved party has already performed, the difference theory would require that he should take back his performance and recover the difference between its value and that of the promised performance. Moreover, the aggrieved party who has not yet rendered performance may have an interest in getting rid of the subject-matter of the performance. In such a case, he is entitled to tender performance and to claim damages on the basis of the exchange theory.²⁷⁰¹ Thus, the courts will generally apply the difference theory, but they will not do so where it leads to inconvenient results and, thus, the aggrieved party may only demand the whole amount of damages under the exchange theory if he has already performed or if he has a particular interest in rendering his own performance.²⁷⁰²

German law recognizes two modes of assessment of damages: abstract assessments of damages, where the damages are measured by an abstract standard such as the market value of what the creditor would have received, and concrete assessment on the basis of a “concrete” substitute transaction. Under the general law of sale in Germany, when the seller fails to deliver, the buyer may seek to enforce either the concrete or the abstract measure of damages. Under the concrete measure, the buyer will recover the difference between the cost of actual substitute transaction and the contract price, or, if actual substitute is not available, the difference between the contract price and the price he would have obtained from selling the goods to a third party, i.e. the price of a hypothetical substitute purchase. Alternatively, the buyer may claim the difference between the contract price and the market price of the goods had he been able to resell them. An abstract assessment of damages in effect alleviates the burden of proving the loss which lies upon the creditor. In the case of a commercial sale of goods, the abstract measure of damages is privileged over a concrete assessment when the buyer or the seller claims damages for delay.²⁷⁰³

In German law, the general principle is that a penalty clause is valid and enforceable. Section 340 (1) of the Civil Code provides that where the penalty is promised for non-performance the creditor may claim the penalty in lieu of performance, and if he demands the penalty his claim for performance is excluded. Section 341 (1) provides that if the penalty is promised for failure to perform properly, including delayed performance, the creditor may demand the penalty in addition to performance. For both cases, Sections 340 (2) and 341 (2) provide that, where the creditor claims compensation for non-performance, he is entitled to the penalty as a minimum sum, and that a claim for further damages is not excluded. Section 343 of the Civil Code provides that if the penalty is unreasonably high it can be reduced by the court to a reasonable sum. The court applying this provision takes into consideration whether the penalty clause aimed at enriching a party or maliciously impoverishing the other party. It also considers the interest which the creditor had in performance, the previous behavior of the debtor, the economic position of the debtor, and the comparative fault of the parties. Section 348 of the German Commercial Code prevents the courts from reducing the agreed amount of penalty promised by a merchant operating a commercial concern on the basis of Section 343 of the Civil Code. However, in commercial cases, the enforcement of the penalty clause could still amount to an exercise of contractual rights against good faith, and Section 242 of the Civil Code may be applicable to allow for review of the amount of penalty. If the penalty clause is not challenged under these considerations, or the challenge has failed, the penalty

²⁷⁰¹ Ibid., at 52

²⁷⁰² Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 996-997

²⁷⁰³ Ibid., at 1035

will be payable in case of non-performance regardless of whether loss has been suffered or not.²⁷⁰⁴

In common law, damages are the primary remedy for breach of contract.²⁷⁰⁵ The basic principle with regard to the purpose and measure of damages for breach of contract was formulated in the case of *Robinson v Harman* in 1848: “the rule of the common law is, that where a party sustains loss by reason of a breach of contract, he is, so far as money can do it to be placed in the same situation, with respect to damages, as if the contract had been performed.”²⁷⁰⁶ This is the general rule under common law, and an award of damages for breach of contract principally seeks to protect the aggrieved party’s expectation interest.²⁷⁰⁷ Under common law, the expectation interest covers the elements of actual loss and the loss of profits, because the contract will have been entered into with a view to making profit and the protection of that expectation of profit will adequately protect the interests of the aggrieved party. Even so, the remedy of damages is in principle based on expectation less the amount saved by the aggrieved party in consequence of the breach, which will include the expenses saved in consequence of being relieved of the obligation to perform.²⁷⁰⁸

Originally, common law did not distinguish between the positive and negative interest. The American jurist Fuller, in his famous article with Perdue,²⁷⁰⁹ adopted the parallel distinction between the expectation interest, the reliance interest and the restitution interest,²⁷¹⁰ and this terminology has influenced English and US case law.²⁷¹¹ Thus, under common law, an

²⁷⁰⁴ Ibid., at 1058

²⁷⁰⁵ Treitel, G.H., *Remedies for Breach of Contract* (Courses of Action Open to a Party Aggrieved), *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 24

²⁷⁰⁶ 1 Ex Rep 850, 855

²⁷⁰⁷ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 404; Restatement (Second) of Contracts, Section 347 (Measure of Damages in General): “Subject to the limitations stated in §§350-53, the injured party has a right to damages based on his expectation interest as measured by (a) the loss in the value to him of the other party’s performance caused by its failure or deficiency, plus (b) any other loss, including incidental or consequential loss, caused by the breach, less (c) any cost or other loss that he has avoided by not having to perform.”

²⁷⁰⁸ Treitel, G.H., *Remedies for Breach of Contract* (Courses of Action Open to a Party Aggrieved), *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 52

²⁷⁰⁹ Fuller, L. L., & William R Perdue, Jr., *The Reliance Interest in Contract Damages*: 1, *Yale Law Journal*, 46 (1936), at 52-96

²⁷¹⁰ An aggrieved party may assert the protection of restitution interest with a view to depriving the non-performing party of a gain which he has made at the aggrieved party’s expense rather than getting compensated for the loss which he has suffered. However, the claimant can obtain restitutionary remedy only when he can establish that the defendant was enriched, that the enrichment was at the claimant’s expense and that it is unjust that the defendant retains the benefit without recompensing the claimant. Where the ground on which restitution is sought is the breach of contract, a restitutionary remedy is available only within very narrow confines. In English law, the aggrieved party may seek a restitutionary remedy either on the ground that the basis upon which he has conferred benefit on the other party has failed because of the breach of contract, or on the ground that the other party has, as a result of his breach of contract, obtained an unjust benefit, in the form of a profit which he would not otherwise have made. McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 404, at 403, 410-413; Restatement (Second) of Contracts (1981), Section 344 (Purposes of Remedies), Comment c.; Restatement (Second) of Contracts (1981), Section 373 (Restitution When Other Party Is In Breach), Comment a.

²⁷¹¹ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law* (*Ius Commune Casebooks for the Common Law of Europe*): 5, Hart Publishing; 2nd Revised edition, 2010, at 997; Restatement (Second) of Contracts, Section 344. (Purposes Of Remedies): “Judicial

aggrieved party may claim the protection of his reliance interest because, for example, the loss of profit is hard to prove.²⁷¹² In that case, the award of damages should compensate him to the extent that he has relied to his detriment upon the promise of the defendant and put the claimant in as good a position as he was in before the promise was made. Although the principle is that the aggrieved party is entitled to choose between claiming on an expectation and a reliance basis, sometimes the court may award reliance loss, even though the aggrieved party claims for loss of expectation, where the value of his expectation is too uncertain to enable the court to base an award upon it.²⁷¹³ Moreover, in the United States, it is generally recognized that an aggrieved party claiming damages on a reliance basis should not be put into a position better than that in which he would have been if the contract had been performed.²⁷¹⁴ In such cases that the loss suffered by the aggrieved party in excess of his expectation is suffered because the contract was a bad bargain for him, the principle is that the court will not, by an award of reliance loss, put the aggrieved party into a position demonstrably better than that in which he would have been if the contract had been performed.²⁷¹⁵ Similarly, in English law, although the aggrieved party has a right to elect whether to claim for loss of bargain damages or for wasted expenditure, this general right of election is subject to an exception where the claimant seeks to recover his reliance loss in an attempt to escape the consequences of his bad bargain or to reverse the contractual allocation of risk.²⁷¹⁶ In view of this limitation, the aggrieved party apparently has no effective right of election between expectation and reliance interest, because a claim for reliance interest is only available where the aggrieved party had not suffered or could not prove a loss of profit.²⁷¹⁷

English law refers mainly to an abstract method in the calculation of damages. For example, in sales contracts, the reasoning for the precedence of abstract method is that if the buyer has paid more than the current market price for the replacement of goods, he has not acted reasonably, and, if he has managed to get them for less, this is a profitable deal he would have

remedies under the rules stated in this Restatement serve to protect one or more of the following interests of a promisee: (a) his "expectation interest," which is his interest in having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed, (b) his "reliance interest," which is his interest in being reimbursed for loss caused by reliance on the contract by being put in as good a position as he would have been in had the contract not been made, or (c) his "restitution interest," which is his interest in having restored to him any benefit that he has conferred on the other party."

²⁷¹² McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 404; Restatement (Second) of Contracts, Section 349, (Damages Based On Reliance Interest): "As an alternative to the measure of damages stated in § 347, the injured party has a right to damages based on his reliance interest, including expenditures made in preparation for performance or in performance, less any loss that the party in breach can prove with reasonable certainty the injured party would have suffered had the contract been performed."

²⁷¹³ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 36

²⁷¹⁴ Restatement (Second) of Contracts, Section 349, Comment a.: "If the injured party's expenditures exceed the contract price, it is clear that at least to the extent of the excess, there would have been a loss. For this reason, recovery for expenditures under the rule stated in this section may not exceed the full contract price."

²⁷¹⁵ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 37

²⁷¹⁶ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 419

²⁷¹⁷ *Toohy and McHugh JJ in Commonwealth of Australia v. Amann Aviation Pty Ltd* (1991) 174 CLR 64, 136, 162

been able to make anyway so that he should keep any profit.²⁷¹⁸ In the United States, the principle of concrete assessment of damages is available under the provisions of the Uniform Commercial Code, entitling a buyer of goods to cover and a seller to resell in good faith and in a commercially reasonable manner in the event of the opposite party's breach.²⁷¹⁹ If the aggrieved party does not resell or cover, damages are assessed abstractly, by reference to market prices.²⁷²⁰ Where the aggrieved party does resell or cover, market prices are relevant only in determining whether the actual cover transaction satisfied the requirement of reasonableness.²⁷²¹

There are two additional measures of damages that can put the aggrieved party in the position which he would have been in had the contract been performed according to its terms, particularly in the cases involving construction contracts under common law. The first is the difference in value between what the aggrieved party has received and what he expected to receive, and the second is the cost of putting the aggrieved party into the position which he would have been in had the contract been fully performed. Section 348 (2) of the Restatement Second Contracts provide that if a breach results in defective or unfinished construction and the loss in value to the injured party is not proved with sufficient certainty, he may recover damages based on (a) the diminution in the market price of the property caused by the breach, or (b) the reasonable cost of completing performance or of remedying the defects if that cost is not clearly disproportionate to the probable loss in value to him. Thus, the Restatement recognizes these bases of assessment of damages in construction contracts provided that the loss in value to the injured party is not proved with sufficient certainty. However, the Restatement explains that if the damages based on the cost to remedy the defects would give the injured party a recovery greatly in excess of the loss in value to him, or if an award based on the cost to remedy the defects would clearly be excessive and the injured party does not prove the actual loss in value to him, damages will be based instead on the difference between the market price that the property would have had without the defects and the market price of the property with the defects, as this solution reflects the least possible loss in value to the injured party since he could always sell the property on the market even if it had no special value to him.²⁷²² In such cases, if there is no diminution in market price of the property due to the defects, the injured party can recover only nominal damages.²⁷²³

In English law, as implied by the House of Lords in *Ruxley Electronics and Construction Ltd. v. Forsyth*, the court is not confined to a straight choice between the two measures, in the sense that the rejection of one necessarily entails the adoption of the other but, if such a stark choice could produce an unjust outcome, the court may exercise its abstract reasoning in determining the recoverable amount of damages when a real loss has been established to

²⁷¹⁸ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1036

²⁷¹⁹ UCC, Sections 2-706 (seller); 2-711 (2) (d) (buyer)

²⁷²⁰ UCC, Sections, 2-708 (seller); 2-713 (buyer)

²⁷²¹ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tubingen: Mohr, 1976, at 45

²⁷²² Restatement (Second) of Contracts, Section 348, Comment c.

²⁷²³ Restatement (Second) of Contracts, Section 348, Comment c., Illustration 4

exist.²⁷²⁴ In some cases, the diminution in value might be zero or a very small amount, and to award such an amount by way of damages for non-performance would make the non-performing party's promise illusory. On the other hand, it might be equally unsatisfactory if the cost of curing the defective performance was so high and out of all proportion to the benefit which the aggrieved party would obtain from it. The House of Lords underlined the role of reasonableness and common sense in deciding whether to award damages on a cost of cure basis or a diminution in value basis or, if both lead to unreasonable results in the particular circumstances of the case, on another basis that utilizes the abstract reasoning of the judge. Thus, the House of Lords set up a flexible framework to ensure a fair outcome in the assessment of damages through its employment of reasonableness as the controlling device.²⁷²⁵

Under common law, the test of foreseeability determines the extent of liability for damages. This test is generally thought to have entered into the common law through the doctrine of remoteness, which can be traced back to the English case of *Hadley v. Baxendale* of 1854.²⁷²⁶ Unlike the principle of foreseeability under French law, there is no suggestion in the rule in *Hadley v. Baxendale* of any special treatment of a debtor who is guilty of "fraud". Both in England and in the United States, it has been very widely thought that *Hadley v. Baxendale* had adopted a test of "foreseeability" in its statement that "Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it."²⁷²⁷

²⁷²⁴ *Ruxley Electronics and Construction Ltd. v. Forsyth*, [1996] 1 A.C. 344, Lord Mustill stated: "In my opinion there would indeed be something wrong if, on the hypothesis that cost of reinstatement and the depreciation in value were the only available measures of recovery, the rejection of the former necessarily entailed the adoption of the latter; and the court might be driven to opt for the cost of reinstatement, absurd as the consequence might often be, simply to escape from the conclusion that the promisor can please himself whether or not to comply with the wishes of the promisee which, as embodied in the contract, formed part of the consideration for the price. Having taken on the job the contractor is morally as well as legally obliged to give the employer what he stipulated to obtain, and this obligation ought not to be devalued. In my opinion, however, the hypothesis is not correct. There are not two alternative measures of damage, at opposite poles, but only one: namely the loss truly suffered by the promisee.... As my Lords have shown, the test of reasonableness plays a central part in determining the basis of recovery, and will indeed be decisive in a case such as the present when the cost of reinstatement would be wholly disproportionate to the non-monetary loss suffered by the employer. But it would be equally unreasonable to deny all recovery for such a loss. The amount may be small, and since it cannot be quantified directly there may be room for difference of opinion about what it should be. But in several fields the judges are well accustomed to putting figures to intangibles, and I see no reason why the imprecision of the exercise should be a barrier, if that is what fairness demands.... There is no need to remedy the injustice of awarding too little by unjustly awarding far too much. The judgment of the trial judge acknowledges that the employer has suffered a true loss and expresses it in terms of money."; Lord Bridge of Harwich stated: "I agree with my noble and learned friend Lord Mustill in the reasons he gives for concluding that there is no reason in principle why the court should not have power to award damages of the kind in question and indeed that in some circumstances such power may be essential to enable the court to do justice." Lord Lloyd of Berwick stated: "I am unable to accept that, in a case such as the present, the judge was presented with such harsh alternatives. He was not bound to award either too little or too much. The law of damages is not so inflexible."

²⁷²⁵ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 410

²⁷²⁶ *Hadley v Baxendale* (1854) 9 Exch 341

²⁷²⁷ *Ibid.*, at 354-355; Treitel, G.H., *Remedies for Breach of Contract* (Courses of Action Open to a Party Aggrieved), *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tubingen: Mohr, 1976, at 60; *Restatement (Second) of Contracts* (1981), Section 351 (Unforeseeability And Related Limitations On Damages)

This test is divided into two parts. The first part qualifies a loss as recoverable if it occurs naturally or as a result of the usual course of things after a breach of contract. The second part allows the recovery of losses, which did not arise naturally, but were within the reasonable contemplation of both parties at the time they made the contract. As the non-performing party must at least know of the special circumstances under the second part of the test, the effect of this part is said to encourage the contracting party to disclose, prior to entry into the contract, the risk of exceptional losses which may be suffered as a result of the non-performance by the other party, and to require the former to pay for some premium in exchange of the latter's assumption of the relevant unpredictable risk.²⁷²⁸ Recently, Lord Hoffman and Lord Hope implied the possible extension of this form of reasoning to the first part of the test in the House of Lords decision of *Transfield Shipping Inc v Mercator Shipping Inc*.²⁷²⁹

²⁷²⁸ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 423-424

²⁷²⁹ [2008] UKHL 48. Lord Hoffmann and Lord Hope held that, even if a loss fell within the first part of test of *Hadley v. Baxendale*, it was not recoverable if, as a matter of construction of the contract, the loss was not one for which the party in breach agreed to accept responsibility at the time of contract. In their opinion, the appropriate test was not simply to determine whether the loss was "of a kind which the defendant, when he made the contract, ought to have realised was not unlikely to result from [the] breach", as explained in the House of Lords decision of *Czarnikow Ltd v Koufos (The Heron II)* [1969] 1 AC 350, at 382-383. In their view, it was more appropriate to ascertain the type and extent of the loss for which the party in breach could reasonably be expected to have assumed responsibility. Lord Hoffmann stated that "It seems to me logical to found liability for damages upon the intention of the parties (objectively ascertained) because all contractual liability is voluntarily undertaken. It must be in principle wrong to hold someone liable for risks for which the people entering into such a contract in their particular market, would not reasonably be considered to have undertaken. The view which the parties take of the responsibilities and risks they are undertaking will determine the other terms of the contract and in particular the price is paid. Anyone asked to assume a large and unpredictable risk will require some premium in exchange. A rule of law which imposes liability upon a party for a risk which he reasonably thought was excluded gives the other party something for nothing." Lord Hoffman concluded that "the implication of a term as a matter of construction of the contract as a whole in its commercial context and the implication of the limits of damages liability seem to me to involve the application of essentially the same techniques of interpretation. In both cases, the court is engaged in construing the agreement to reflect the liabilities which the parties may reasonably be expected to have assumed and paid for. It cannot decline this task on the ground that the parties could have spared it the trouble by using clearer language." Lord Hope similarly noted that the point that was made in the *Heron II* case was "the more unusual the consequence, the more likely it is that provision will be made for it in the contract if it is to result in liability." He concluded that "damages that are recoverable for breach of contract are limited to what happens in ordinary circumstances - in the great multitude of cases, as *Alderson B* put it in *Hadley v Baxendale* - where an assumption of responsibility can be presumed, or what arises from special circumstances known to or communicated to the party who is in breach at the time of entering into the contract which because he knew about he can be expected to provide for. This is a principle of general application. We are dealing in this case with a highly specialised area of commercial law. But the principle by which the issue must be resolved is that which applies in the law of contract generally." Lord Rodger and Baroness Hale, on the other hand, decided the case on the basis of a narrower ground, and as a question of fact, in terms of whether the circumstances surrounding the case were within the reasonable contemplation of the parties, in contrast to Lord Hoffmann's reasoning that recoverability of loss of profits was a question of law, in terms of discerning the intentions of the parties on an interpretation of the contract as a whole. Lord Rodger stated that "it is important not to lose sight of the basic point that, in the absence of special knowledge, a party entering into a contract can only be supposed to contemplate the losses which are likely to result from the breach in question - in other words, those losses which will generally happen in the ordinary course of things if the breach occurs. Those are the losses for which the party in breach is held responsible - the stated rationale being that, other losses not having been in contemplation, the parties had no opportunity to provide for them." Baroness Hale stated that "The rule in *Hadley v Baxendale* asks what the parties must be taken to have had in their contemplation, rather than what they actually had in their contemplation, but the criterion by which this is judged is a factual one. Questions of assumption of risk depend upon a wider range of factors and value judgments." In her opinion, although the result of the reasoning of Lord Hoffmann in this case may be to bring about certainty and clarity in the relevant shipping market, such an imposed limit on liability could easily be at the expense of justice in some future case, and could introduce much room for argument in other contractual contexts.

Under common law, the aggrieved party cannot recover for loss which he could have avoided or mitigated through his reasonable efforts.²⁷³⁰ The aggrieved party is under a duty to mitigate his loss, but he does not incur any liability if he fails to mitigate its loss. The classic formulation of principle relating to mitigation can be found in *British Westinghouse Electric and Manufacturing Company Limited v Underground Electric Railways Company of London Limited*, where Viscount Haldane LC said: “The fundamental basis is thus compensation for pecuniary loss naturally flowing from the breach; but this first principle is qualified by a second, which imposes on a claimant the duty of taking all reasonable steps to mitigate the loss consequent on the breach, and debars him from claiming any part of the damage which is due to his neglect to take such steps.” However, “this does not impose on the plaintiff an obligation to take any step which is reasonable and prudent man would not ordinarily take in the course of his business”.²⁷³¹ Thus, where it is reasonable for an aggrieved party to obtain a substitute performance, an aggrieved party is both obliged and entitled to obtain a substitute performance from a third party without any prior judicial authorization or express provision in the contract itself.

Similarly, Section 350 of the Restatement Second provides that damages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation. Thus, the amount of loss that the injured party could reasonably have avoided by stopping performance, making substitute arrangements or otherwise is subtracted from the amount that would otherwise have been recoverable as damages.²⁷³² Under this rule, the injured party is expected to stop his own performance to avoid further expenditure once he has reason to know that performance by the other party will not be forthcoming, and to arrange a substitute transaction within a reasonable time after he learns of the breach, even if the breach takes the form of an anticipatory repudiation.²⁷³³ However, the injured party is not precluded from recovery for its failure to avoid the loss to the extent that he has made reasonable but unsuccessful efforts to avoid loss, and costs incurred in a reasonable but unsuccessful effort to avoid loss are recoverable as incidental losses. Section 350 aims at encouraging the injured party to make reasonable efforts to avoid loss by protecting him even when his efforts fail.²⁷³⁴

Another limitation under common law is that the aggrieved party will be unable to recover damages in respect of the loss which he has suffered if he cannot establish the causal link between his loss and the other party’s breach of contract.²⁷³⁵ The notion of causation is even reflected in the cases of duty to mitigate. English courts often use the language of causation and consider a claimant’s failure to mitigate as breaking the chain of causation between the defendant’s breach of contract and this unnecessary loss.²⁷³⁶ Similarly, an aggrieved party’s negligence may break the causal link between the defendant’s breach of contract and any loss

²⁷³⁰ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 421; Restatement (Second) of Contracts (1981), Section 350 (Avoidability As A Limitation On Damages)

²⁷³¹ [1912] A.C. 673 at 689

²⁷³² Restatement (Second) of Contracts (1981), Section 350, Comment b

²⁷³³ Restatement (Second) of Contracts (1981), Section 350, Comments b and f

²⁷³⁴ Restatement (Second) of Contracts (1981), Section 350, Comment h

²⁷³⁵ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 426

²⁷³⁶ Whittaker, Simon, *Contributory Fault and Mitigation; Rights and Reasonableness: Comparisons between English and French Law*, in L. Tich (ed.), *Causation in Law*, Univerzita Karlova v Praze, 2007, (at 2 on the file with author)

which may be attributable to it.²⁷³⁷ However, when the aggrieved party has been negligent and that negligence contributed to the damage which he has suffered, but it is not sufficient to break the chain of causation, the question then arises whether the damages, payable to the claimant can be reduced in the common law countries.

Under the Restatement Second Contracts, contract law is strict liability without a contributory negligence defense. Thus, the promisor is liable to the promisee for breach, and that liability is unaffected by the promisor's exercise of due care or failure to take efficient precautions, and the promisor's liability is unaffected by the fact that the promisee, prior to the breach, has failed to take reasonable measures to reduce the consequences of nonperformance.²⁷³⁸ In England, the Law Reform (Contributory Negligence) Act 1945 is primarily covers tort cases, and it has not been clear to what extent the Act also applies to cases of breach of contract. In order to determine the applicability of the Act to the breach of contracts, three categories are distinguished according to the nature of the obligation which is breached: (1) a breach of a strict contractual duty; (2) a breach of a contractual duty to take care, which does not correspond to a common law duty to take care; and (3) a breach of contractual duty of care where the breach also constitutes a tort. It is argued that contributory negligence can operate as a defense only in the third category, where the breach of contract is also a tort.²⁷³⁹

Even so, there are many other legal devices under common law to address the problems related to the contributory or comparative negligence, since the aggrieved party's contributory behavior can also be discussed under headings such as causation, remoteness or foreseeability of damages, or impossibility and frustration.²⁷⁴⁰ For instance, common law recognizes the issue of "concurrent delay" in the construction contracts. The issue arises where a construction has not been completed on time because of two or more delaying events that operate at the same time: one of the delaying events is the responsibility of the employer and the other is the responsibility of the contractor. However, there are various approaches suggested in the common law jurisdictions. First possible approach is the apportionment, which suggests that the delay and its consequences should be apportioned between the contractor and the employer by allocating financial consequences according to the court's perception of the relative causative potency of the competing causes. However, this approach has attracted only very limited support because the courts of common law tend to apply the principles of causation in an 'all or nothing' manner, but it is observed greater readiness to use apportionment in Canada and in New Zealand.²⁷⁴¹ The second possible approach is described

²⁷³⁷ *Sotiros Shipping Inc v Sameiet Solholt* (The "Solholt") [1983] 1 Lloyd's Rep. 605, 608, Sir John Donaldson MR: '[the plaintiff] is completely free to act as he judges to be in his best interests. On the other hand, a defendant is not liable for all loss suffered by the plaintiff in consequence of his so acting. A defendant is only liable for such part of the plaintiff's loss as is properly to be regarded as caused by the defendant's breach'.

²⁷³⁸ Scott, Robert E., In (Partial) Defense of Strict Liability in Contract, *Michigan Law Review*, 107 (June 2009), at 1382

²⁷³⁹ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 1022-1023

²⁷⁴⁰ Treitel, G.H., *Remedies for Breach of Contract: A Comparative Account*, Clarendon Press, 1988, at 189-190

²⁷⁴¹ Marrin, John, Concurrent delay, *Construction Law Journal*, 18-6 (2002), at 440-441: Marrin also noted some indication of a similar development in England. In *Tennant Radiant Heat Limited v. Warrington Development Corporation*, warehouse roof collapsed due to an accumulation of rainwater because of blocked outlets. The tenants' claim in respect of the goods which were damaged was met by a landlords' counterclaim for damages for breach of the repairing covenant. While recognizing that the apportionment provisions of the Law Reform (Contributory Negligence) Act 1945 did not apply, the Court of Appeal nevertheless apportioned the damages,

as the American approach, under which in cases of concurrent delay neither party will recover compensation, unless and to the extent that they can segregate delay associated with each competing cause and prove the delay upon which it relies. The usual result is that the contractor is granted an extension of time relieving it of liability for liquidated damages, but does not recover delay-related loss and damage because of its own inexcusable delay.²⁷⁴² Finally, there is the approach suggested by the English case of *Henry Boot Construction (UK) Ltd v. Malmaison Hotel (Manchester) Ltd.*²⁷⁴³ The judgment registered the common ground between the parties that: “it is agreed that if there are two concurrent causes of delay, one of which is a relevant event [e.g., the owner's change order], and the other is not [e.g., the contractor's insufficient resources], then the contractor is entitled to an extension of time for the period of delay caused by the relevant event notwithstanding the concurrent effect of the other event.” The approach suggests that in allocating risks as between themselves, the parties may be taken, first, to have recognized that any one delay or period of delay might well be attributable to more than one cause but, secondly, to have agreed nevertheless that provided one of those causes affords grounds for relief under the contract, then the contractor should have his relief.²⁷⁴⁴ The decision in the case of *Royal Brompton Hospital NHS Trust v. Hammond (No 7)* seemed to give further support to this approach, by holding that if the contractor was delayed in completing the works both by matters for which it bore the contractual risk and by relevant events within the meaning of the contract, the contractor “would be entitled to extensions of time by reason of the occurrence of the relevant events notwithstanding its own defaults.”²⁷⁴⁵ In the end, in common law, there is no single legal approach to the concurrency issue, although these issues are commonly raised in construction claims. This situation is criticized for leading to uncertainty and unpredictability in the outcome of claims.²⁷⁴⁶

Common law requires that damages must be established with reasonable certainty, and damages, which are speculative, remote, imaginary, contingent, or merely possible, cannot be

treating the matter as one of causation. Dillon LJ stated that “in my judgment, the 1945 Act has no application to the present case... The problem which this court faces on the claim and counterclaim alike is in my judgement a problem of causation of damages. On the claim the question is how far the damage to its goods which the lessee has suffered was caused by the corporation's negligence notwithstanding the lessee's own breach of covenant. On the counterclaim the question is how far the damage to the corporation's building which the corporation has suffered was caused by the lessee's breach of covenant notwithstanding the corporation's own negligence. The effect is that on each question apportionment is permissible. This is the same result as the 1945 Act would produce, but it is not reached through the Act, because the obstacle which the 1945 Act was passed to override is not there on either claim or counterclaim in the present case”. Croom-Johnson LJ stated “If the 1945 Act has no application, what is the position on the two claims? The evidence clearly indicates that the damage to the plaintiff's premises was attributable to two concurrent causes, both operating contemporaneously. One was the defendant's negligence and the other was the plaintiff's breach of covenant. I agree with the finding of Dillon L.J. that simply as a matter of causation, based upon the amount of water which was wrongfully on the roof, the plaintiff's breach of covenant was a factor of one-tenth of that united cause, and the defendant's negligence a factor of nine-tenths.” *Tennant Radiant Heat Ltd v Warrington Development Corporation* [1988] 1 E.G.L.R. 41

²⁷⁴² Marrin, John, Concurrent delay, *Construction Law Journal*, 18-6 (2002), at 443-444

²⁷⁴³ [1999] 70 Con LR 32

²⁷⁴⁴ Marrin, John, Concurrent delay, *Construction Law Journal*, 18-6 (2002), at 448: This is the preferred option by John Marrin because, in his view, “it is readily justifiable on the grounds that it represents the kind of allocation of risk as between the parties which is only to be expected.”

²⁷⁴⁵ *Royal Brompton Hospital NHS Trust v Hammond and Others (No. 7)* [2001] 76 ConLR 148

²⁷⁴⁶ Ramsey, Vivian, Problems of Delay and Disruption Damages in International Construction Arbitration, in Yves Derains & Richard H. Kreindler, (eds.), *Evaluation of Damages in International Arbitration*, ICC Publication No. 668, 2006, at 204

recovered.²⁷⁴⁷ The certainty rule generally applies to the existence of loss, rather than the extent of loss. If the aggrieved party provides sufficient evidence of loss or damage, the fact that the amount of damages is difficult to assess is generally not a bar to recovery.²⁷⁴⁸ Doubts are generally resolved against the party in breach in view of the fact that the party in breach has forced the aggrieved party to seek compensation in damages and, thus, he should not be allowed to profit from his breach where it is established that a significant loss has occurred.²⁷⁴⁹ Accordingly, the courts in common law countries have been willing to award damages for lost profits and the loss of a chance.²⁷⁵⁰ Moreover, in the United States, while fault of the non-performing party has no bearing on liability for breach, the courts have been less demanding in applying the requirement of certainty if the breach was willful.²⁷⁵¹ In the end, the rule of certainty underlines that damages need not be calculable with mathematical accuracy and are often approximate.²⁷⁵²

²⁷⁴⁷ Treitel, G.H., *Remedies for Breach of Contract* (Courses of Action Open to a Party Aggrieved), *International Encyclopedia of Comparative Law*, Vol. 7 Ch. 16, Tubingen: Mohr, 1976, at 83-84

²⁷⁴⁸ Gotanda, John Y., *Damages in private international law*, *Receuil des Cours*, 326 (2007), at 102; Restatement (Second) of Contracts (1981), Section 352, Comment a: "The requirement does not mean, however, that the injured party is barred from recovery unless he establishes the total amount of his loss. It merely excludes those elements of loss that cannot be proved with reasonable certainty."

²⁷⁴⁹ Restatement (Second) of Contracts (1981), Section 352, Comment a.

²⁷⁵⁰ *Chaplin v. Hicks* [1911] 2 KB 786: The plaintiff was a semifinalist in a beauty contest. The promoter of the event breached the contract by failing to notify the plaintiff of the time and place of the competition. The jury awarded damages in the amount of one fourth of the lowest prize. The Court of Appeals indicated the chance of winning had value which could be assessed by the law of averages. *Allied Maples Group Ltd v. Simmons & Simmons* [1995] 1 WLR 1602: A solicitor's negligence deprived the claimant of an opportunity to negotiate a better bargain. The Court of Appeal held that where the loss depends on the hypothetical action of a third party, the claiming party only has to prove that there is a substantial chance that the third party would have acted so as to confer the benefit or avoid the risk, the evaluation of the substantial chance being a question of quantification of damages. *Taylor v. Bradley*, 39 N.Y. 129 (1868): A landowner breached its contract with a farmer by reneging on a promise to allow the latter to use the land. The Court of Appeals of New York determined that justice required the farmer receive the value of his contract and held that its damages were what he lost by being deprived of his chance of profit. *Story Parchment Co. v. Paterson Parchment Paper Company*, 282 U.S. 555, 563 (1931): the U. S. Supreme Court held that to deny an injured party the right to recover damages that clearly arise from the breach because it is of a kind that cannot be measured with certainty would allow wrongful acts to be profitable. The Court further explained that no part of the loss should be left upon the injured party simply because the defendant's wrongful act prevented the precise amount from being fixed. Restatement (Second) of Contracts, Section 348(3) (1981): "If a breach is of a promise conditioned on a fortuitous event and it is uncertain whether the event would have occurred had there been no breach, the injured party may recover damages based on the value of the conditional right at the time of the breach." The comment explains that "a breach that occurs before the happening of the fortuitous event may make it impossible to determine whether the event would have occurred had there been no breach. It would be unfair to the party in breach to award damages on the assumption that the event would have occurred, but equally unfair to the injured party to deny recovery of damages on the ground of uncertainty. The injured party has, in any case, the remedy of restitution (see § 373). Under the rule stated in Subsection (3) he also has the alternative remedy of damages based on the value of his conditional contract right at the time of breach, or what may be described as the value of his "chance of winning." The value of that right must itself be proved with reasonable certainty, as it may be if there is a market for such rights or if there is a suitable basis for determining the probability of the occurrence of the event." Restatement (Second) of Contracts, Section 348(3) (1981) comment d.

²⁷⁵¹ Gotanda, John Y., *Damages in private international law*, *Receuil des Cours*, 326 (2007), at 128; Restatement (Second) of Contracts (1981), Section 352, Comment a.: "A court may take into account all the circumstances of the breach, including willfulness, in deciding whether to require a lesser degree of certainty, giving greater discretion to the trier of the facts."

²⁷⁵² Restatement (Second) of Contracts (1981), Section 352, Comment a.; *The Heron II, Koufos v. Czamikow* [1969] 1 A.C. 350, 425 (H.L. 1969): "the assessment of damages is not an exact science".

Common law divides contractual clauses for the payment of a sum of money in the event of breach into two kinds, as being penalty clauses and liquidated damages clauses. The distinction is based on the function of the clause. If the clause is a genuine attempt to pre-estimate the loss, which is likely to arise from the breach, it is a valid liquidated damages clause, and can be enforced. The function of such a clause is to fix the sum which is to be paid irrespective of the actual loss. Thus, the aggrieved party is entitled to the agreed sum under a liquidated damages clause, whether his actual, or recoverable, loss amounted to more or to less. The aggrieved party cannot ignore such a clause and sue for his actual loss, and there is no judicial power to modify valid liquidated damages clauses. On the other hand, if the clause is not a genuine pre-estimate of loss, it is a penalty clause and unenforceable. The function of such a clause is to punish the party in breach and intended as a means of coercing that party into performing its obligations. Such a clause is invalid and disregarded, and the aggrieved party can only claim his actual loss.²⁷⁵³

The distinction between a liquidated damages clause and a penalty clause is based ultimately on the intention of the parties at the time of entry into the contract. Thus, it is a question of interpretation, and the courts have established a number of rules in deciding whether a particular clause is a penalty clause or a liquidated damages clause.²⁷⁵⁴ First, in English law, a stipulation will be a penalty if it is “extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach”.²⁷⁵⁵ In the United States, a stipulation will be a penalty if the agreed amount is unreasonable in the light of the anticipated or actual harm caused by the breach.²⁷⁵⁶ The second rule is that a stipulation will be regarded as a valid liquidated damages clause if the circumstances were such that an accurate or precise pre-estimate of damages was almost impossible, but the stipulated sum was in fact a genuine attempt to make a reasonable pre-estimate.²⁷⁵⁷ Thirdly, in the situation in which a single sum is payable on one or more or all of several breaches, which may occasion different amounts of damage, there is a presumption that the sum is a penalty on the ground that it cannot be a genuine pre-estimate of damage for all the breaches.²⁷⁵⁸ The

²⁷⁵³ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 101

²⁷⁵⁴ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 438-439

²⁷⁵⁵ *Dunlop Pneumatic Tyre Company Ltd v. New Garage & Motor Co Ltd* [1915] AC 79, at 87

²⁷⁵⁶ Restatement (Second) of Contracts (1981), Section 356 (Liquidated Damages And Penalties); UCC, Section 2-718; This approach was also adopted by the English case, *Alfred McAlpine Capital Projects Limited v Tilebox Limited* [2005] EWHC 281 (TCC), where Jackson J stated that “There seem to be two strands in the authorities. In some cases judges consider whether there is an unconscionable or extravagant disproportion between the damages stipulated in the contract and the true amount of damages likely to be suffered. In other cases the courts consider whether the level of damages stipulated was reasonable.... these two strands can be reconciled. In my view, a pre-estimate of damages does not have to be right in order to be reasonable. There must be a substantial discrepancy between the level of damages stipulated in the contract and the level of damages which is likely to be suffered before it can be said that the agreed pre-estimate is unreasonable.”

²⁷⁵⁷ Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 101; *Dunlop Pneumatic Tyre Company Ltd v. New Garage & Motor Co Ltd* [1915] AC 79; Restatement (Second) of Contracts (1981), Section 356, Comment b.: “The greater the difficulty either of proving that loss has occurred or of establishing its amount with the requisite certainty (see § 351), the easier it is to show that the amount fixed is reasonable.”

²⁷⁵⁸ *Dunlop Pneumatic Tyre Company Ltd v. New Garage & Motor Co Ltd* [1915] AC 79; Treitel, G.H., *Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved)*, International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tübingen: Mohr, 1976, at 102

fourth rule is that a stipulation is a penalty “if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than that which ought to have been paid.”²⁷⁵⁹ It should be noted that, in applying these rules, the courts consider the exceptional nature of invalidity of a contractual term as being penal or oppressive, particularly when the relevant clause has been agreed by commercial parties who are capable of protecting their own interests in the bargaining process.²⁷⁶⁰

Under common law, a liquidated damages clause may validly provide for the payment of an amount, which is less than the estimated loss, but where the clause is held to exclude or restrict liability, it may be subject to, and invalidated by, the application of relevant rules on limitation of liability. In the United States, the doctrine of unconscionability is relevant to the determination of validity of exemption or limitation clauses.²⁷⁶¹ Although English law does not recognize the existence of a general doctrine of unconscionability, Unfair Commercial Terms Act 1977 provides means of controlling many exclusion or limitation clauses.²⁷⁶² According to Section 2 of the Act, a contract entered into in the course of business cannot exclude liability for death or personal injury resulting from negligence; nor for other loss or damage resulting from negligence except so far as the term is reasonable.²⁷⁶³ Thus, in those cases, the validity of limitation or exemption clauses will sometimes be assessed according to their “reasonableness”.²⁷⁶⁴ However, the Act does not apply to international contracts in certain cases.²⁷⁶⁵

²⁷⁵⁹ *Dunlop Pneumatic Tyre Company Ltd v. New Garage & Motor Co Ltd* [1915] AC 79

²⁷⁶⁰ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 440

²⁷⁶¹ Section 356 of the Restatement (Second) of the Contracts provides in Comment (a) that “A term that fixes an unreasonably small amount as damages may be unenforceable as unconscionable.” According to Section 208 of the Restatement (Second) of the Contracts, if a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result. Similarly, Section 2-719 of the UCC provides that the parties may limit or alter the measure of damages recoverable and limit or exclude consequential damages, unless the limitation or exclusion is unconscionable. In more general terms, Section 2-302 of the UCC provides that if the court as a matter of law finds the contract or any term of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable term, or it may so limit the application of any unconscionable term as to avoid any unconscionable result.

²⁷⁶² McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 235

²⁷⁶³ “Negligence” is defined in Section 1 (1) as “the breach (a) of any obligation, arising from the express or implied terms of a contract, to take reasonable care or exercise reasonable skill in the performance of the contract; (b) of any common law duty to take reasonable care or exercise reasonable skill (but not any stricter duty); (c) of the common duty of care imposed by the Occupiers’ Liability Act 1957 or the Occupiers’ Liability Act (Northern Ireland) 1957.” Moreover, Section 3 provides that a contract entered into, in the course of business, on the written standard terms of one party cannot enable that party to exclude liability for breach, to perform the contract substantially differently from that which was reasonably expected, or not to perform it at all except so far as such provision is reasonable.

²⁷⁶⁴ Section 11 (1) of the Act provides that “in relation to a contract term, the requirement of reasonableness ... is that the term shall have been a fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made.”

²⁷⁶⁵ Section 26 of the Act provides that the limits imposed by this Act on the extent to which a person may exclude or restrict liability by reference to a contract term do not apply to liability arising under an international supply agreement, which is defined by Sections 26 (3) and (4), nor are the terms of such a contract subject to any requirement of reasonableness under Section 3 or 4. Moreover, Section 27 (1) provides that, where the law applicable to a contract is the law of any part of the United Kingdom only by choice of the parties, sections 2 to 7 of this Act do not operate as part of the law applicable to the contract. However, Section 27(2) provides that

b. International Instruments

Under the CISG, Articles 45 and 61 provide that if the seller or buyer fails to perform any of his obligations under the contract or the Convention, the other party may “claim damages as provided in Articles 74 to 77.”²⁷⁶⁶ The notion of breach of contract is the substantive condition for claiming damages, and means the non-fulfillment of any of the obligations undertaken by the seller or the buyer, regardless of whether they are of major or minor importance. Under the CISG, damages for non-performance are available independent of any fault. The claim for damages serves to complete the system of remedies under the CISG by providing the parties with compensation in cases where other remedies do not lead to an adequate compensation.²⁷⁶⁷ Thus, the aggrieved party “is not deprived of any right he may have to claim damages by exercising his right to other remedies”.²⁷⁶⁸ Finally, Articles 45 (3) and 61 (3) provides that no period of grace may be granted to the seller or the buyer by a court or arbitral tribunal when the other party resorts to a remedy for breach of contract, since it is thought that this would subject the parties to the broad discretionary power of a judge or arbitrator and lead to inappropriate consequences in the context of international commerce.²⁷⁶⁹ Each party on its own motion may grant a period of grace to the other party without losing his right to claim damages.²⁷⁷⁰

The basic principle for the calculation of damages is set forth in Article 74 of the CISG. It provides the general rule for the calculation of damages. Article 74 provides that “Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach.” The article incorporates the expectation (positive) interest, a standard that is designed to place the aggrieved party in as good a position as if the other party had properly performed the contract.²⁷⁷¹ Moreover, Article 74 is based on the principle of full compensation, where damages consist in compensation of *damnum emergens* and *lucrum cessans*. Under Article 74, damages are typically measured by the value of the benefit of which the aggrieved party has been deprived due to the breach, or by the costs of reasonable measures to bring about the situation that would have existed had the contract been properly performed.²⁷⁷² For instance, where the seller delivers and the buyer retains defective goods, the loss suffered by the buyer might be measured in a number of different ways. The buyer is authorized to claim damages equal to

the controls contained in the Act cannot be evaded by the choice of law clause outside the United Kingdom as the governing law, if it appears that the choice of law was imposed wholly or mainly for the purpose of enabling the party imposing it to evade the operation of this Act.

²⁷⁶⁶ Articles 45(1)(b) and 61(1)(b) of the CISG

²⁷⁶⁷ Will, Michael, Article 45, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 331-332

²⁷⁶⁸ Articles 45(2) and 61(2) of the CISG

²⁷⁶⁹ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 303; Knapp, Victor, Article 61, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 449

²⁷⁷⁰ Articles 47 and 63 of the CISG

²⁷⁷¹ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 445

²⁷⁷² CISG-AC Opinion No. 6, *Calculation of Damages under CISG Article 74*. Rapporteur: Professor John Y. Gotanda, Villanova University School of Law, Villanova, Pennsylvania, USA, 2006, at para. 3

the difference of the value of the goods as contracted and the value of the defective goods received. If the buyer is able to cure the defect, his loss would often equal the cost of the repairs.²⁷⁷³ The buyer may also claim loss of profits.

Although the CISG does not provide specific guidance on calculating lost profits, CISG Advisory Council, in its Opinion No. 6, suggested that Article 74 should be understood as entitling the aggrieved party to claim net profits lost as a result of the breach of contract, which is to be calculated by subtracting from gross profits the expenses saved as a result of the aggrieved party being excused from performance.²⁷⁷⁴ Thus, since the remedy of damages must not place the aggrieved party in a better position than it would have enjoyed if the contract had been properly performed, the loss to the aggrieved party resulting from the breach should be offset, in calculating the amount of damages, by any gains to the aggrieved party resulting from the non-performance of the contract.²⁷⁷⁵ The Advisory Council also expressed the opinion that damages for the loss of a chance or opportunity to profit ordinarily are not recoverable under Article 74, but when the aggrieved party purposely enters into a contract in order to obtain a chance of earning a profit, the chance of profit should be considered as an asset, and allowing recovery in this circumstance would be consistent with the full compensation principle of Article 74.²⁷⁷⁶

Article 74 also provides the principle of foreseeability: “damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract.” Thus, the party in breach will be liable even for loss indirectly caused to the other party provided that this loss was foreseeable, within the meaning of Article 74, by the party in breach at the time of the conclusion of the contract. Under the foreseeability test, the party in breach will be considered as knowing the facts and matters enabling him to foresee the consequences of the breach of contract if such knowledge can be expected of him, having regard to his experience as a merchant in the particular case. The party in breach will also be considered as able to foresee the possible consequences of the breach, whenever the other party to the contract has drawn his attention to such possible consequences in due time.²⁷⁷⁷ However, Article 74 does not adopt the rule, which excludes the applicability of the foreseeability test if the non-performance of the contract was due to the fraud of the non-performing party.

It is unclear whether the CISG contains a certainty requirement for awarding damages. The CISG does not explicitly require proof of harm in order for an aggrieved party to recover damages.²⁷⁷⁸ There has been controversy over whether the issue of certainty is addressed by

²⁷⁷³ Knapp, Victor, Article 74, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 546

²⁷⁷⁴ CISG-AC Opinion No. 6, *Calculation of Damages under CISG Article 74*. Rapporteur: Professor John Y. Gotanda, Villanova University School of Law, Villanova, Pennsylvania, USA, 2006, at para. 3.14

²⁷⁷⁵ *Ibid.*, at para. 9

²⁷⁷⁶ *Ibid.*, at para. 3.15

²⁷⁷⁷ Knapp, Victor, Article 74, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 542

²⁷⁷⁸ In *Delchi Carriers v. Rotorex Corp.*, the United States Court of Appeals for the Second Circuit agreed with the trial court that the claimant was only entitled to those damages that it could prove with sufficient certainty, and held that the traditional common law damage limitation that the claimant must provide sufficient evidence to

the Convention or whether it is a procedural matter that should be resolved by the applicable national law.²⁷⁷⁹ The CISG Advisory Council, in its Opinion No. 6, addressed the question and maintained that the aggrieved party has the burden to prove, with reasonable certainty, that it suffered a loss, and the extent of the loss, but need not do so with mathematical precision. This requirement of reasonable certainty was seen as consistent with the UNIDROIT Principles and the PECL, and in accordance with many national laws. The opinion was established on the basis of the need to promote the Convention's international character and the need to promote uniformity in the Convention's application, and in light of the purposes and policies of Article 74.²⁷⁸⁰

Articles 75 and 76 of the CISG set forth methods for calculating damages when a contract has been avoided. Articles 75 and 76 do not replace Article 74, but provide the aggrieved party with alternative methods that may be used to measure damages when a contract has been avoided.²⁷⁸¹ The major advantage for the parties of proceeding under Article 75 or 76 is that, as a rule, the foreseeability requirement under Article 74 will not be applicable as the types of damages described in those two provisions are deemed to be foreseeable.²⁷⁸² Moreover, both Articles 75 and 76 explicitly provide that further damages may be claimed under Article 74. Article 75 adopts the concrete method for calculating the damages in case of avoidance, and entitles the aggrieved party to recover as damages the difference between the contract price and the price of the substitute transaction, provided that the aggrieved party made a substitute transaction in a reasonable manner and in a reasonable time after avoidance. For the substitute transaction to have been made in a reasonable manner within the context of Article 75, it must have been made in such a manner as would be likely to bring the highest price reasonably possible on a seller's resale or the lowest price reasonably possible on a buyer's cover purchase. The reasonable period of time for the resale or the cover purchase will not begin until the aggrieved party has in fact declared the contract avoided.²⁷⁸³ In the event that the aggrieved party's substitute transaction was unreasonable, damages may be calculated according to Article 76 or Article 74.²⁷⁸⁴

If the aggrieved party has avoided the contract but has not entered into a substitute transaction, Article 76 allows the abstract calculation of damages under certain conditions. Under Article 76, an aggrieved party is entitled to recover as damages measured by "the difference between the price fixed by the contract and the current price". Article 76 provides an alternative means to Article 75 for determining damages when the contract has been

estimate damages with reasonable certainty should apply since the CISG did not address the issue. *Delchi Carriers SpA v. Rotorex Corp.*, 171 F. 3d 1024 (2d Cir. 1995), 1029, 1031

²⁷⁷⁹ Gotanda, John Y., *Damages in private international law*, *Receuil des Cours*, 326 (2007), at 155

²⁷⁸⁰ CISG-AC Opinion No. 6, *Calculation of Damages under CISG Article 74*. Rapporteur: Professor John Y. Gotanda, Villanova University School of Law, Villanova, Pennsylvania, USA, 2006, at para. 2

²⁷⁸¹ CISG-AC Opinion No. 8, *Calculation of Damages under CISG Articles 75 and 76*. Rapporteur: Professor John Y. Gotanda, Villanova University School of Law, Villanova, Pennsylvania, USA, 2008, at para. 1.2

²⁷⁸² Huber, Peter, & Alastair Mullis, *The CISG: A New Textbook for Students and Practitioners*, Sellier European Law Publishers, 2007, at 283

²⁷⁸³ Secretariat Commentary, art. 71 [draft counterpart to CISG art. 75], paras. 4-5 (available at <http://cisgw3.law.pace.edu/cisg/text/secomm/secomm-75.html>)

²⁷⁸⁴ CISG-AC Opinion No. 8, *Calculation of Damages under CISG Articles 75 and 76*. Rapporteur: Professor John Y. Gotanda, Villanova University School of Law, Villanova, Pennsylvania, USA, 2008, at para. 2.4; Secretariat Commentary, art. 71 [draft counterpart to CISG art. 75], para. 6 (available at <http://cisgw3.law.pace.edu/cisg/text/secomm/secomm-75.html>)

avoided. However, a concrete determination of damages under Article 75 is generally preferred to abstract determination under Article 76, and ordinarily takes precedence if the requirements of Article 75 are met.²⁷⁸⁵ Article 76 may be used, instead of Article 75, to calculate damages where the aggrieved party is constantly dealing in “market transactions” and it is therefore difficult or impossible to determine which particular transaction should be considered the cover for the breached contract.²⁷⁸⁶ Abstract method under Article 76 is only available if the contract goods have a current price, which is the price generally charged for such goods sold under comparable circumstances in the trade concerned. The time at which the current price is to be established is the time of avoidance, namely the moment when avoidance was declared.²⁷⁸⁷ However, pursuant to Article 76 (1), if the aggrieved party avoids the contract after taking over the goods, the current price is to be determined at the time of such taking over, which is prior to the time of avoidance. The latter provision aims at preventing speculation on price movements by the aggrieved party who has avoided the contract after taking over the goods, by postponing avoidance of the contract until the expected rise or fall in the current price of the goods in question.²⁷⁸⁸ The location at which the current price is to be established is the place where the delivery of the goods should have been made. If there is no current price at the place of delivery, Article 76 (2) provides that the current price will be “the price at such other place as serves as a reasonable substitute, making due allowance for differences in the cost of transporting the goods.”

Article 77 sets forth the aggrieved party’s duty to mitigate the loss resulting from the breach. It requires a party wishing to assert claims based on breach of contract to take reasonable measures to mitigate his loss. A violation of this duty leads to a corresponding reduction in damages, which is the only remedy available for the violation of this duty. Thus, unlike other obligations of the seller and of the buyer under the Convention, the obligation under Article 77 cannot be directly enforced, and failure to comply with it is no ground for avoidance of the contract.²⁷⁸⁹ The aggrieved party is not obliged to take measures which, although they may mitigate the loss, would be excessive. The expenses of the aggrieved party in taking measures to mitigate his loss will be recoverable even if those measures were in vain, provided that they were reasonable under the circumstances.²⁷⁹⁰ Reasonable measures to mitigate the loss will typically be a resale of the goods by the seller or a cover purchase by the buyer. The duty to mitigate the loss may also apply to an anticipatory breach of contract under Article 71. When it becomes clear that one party will commit a fundamental breach of contract, if the aggrieved party does not suspend his performance under Article 71(3) or declare the contract avoided under Article 72, but insists on specific performance of the contract, he risks, on claiming damages, being found to have failed to take appropriate measures to mitigate the threatened loss. In such a case, the aggrieved party, if he wishes to comply with Article 77, cannot await

²⁷⁸⁵ CISG-AC Opinion No. 8, Calculation of Damages under CISG Articles 75 and 76. Rapporteur: Professor John Y. Gotanda, Villanova University School of Law, Villanova, Pennsylvania, USA, 2008, at para. 4.1.2

²⁷⁸⁶ Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 97

²⁷⁸⁷ CISG-AC Opinion No. 8, Calculation of Damages under CISG Articles 75 and 76. Rapporteur: Professor John Y. Gotanda, Villanova University School of Law, Villanova, Pennsylvania, USA, 2008, at para. 4.4.1

²⁷⁸⁸ Knapp, Victor, Article 76, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 556

²⁷⁸⁹ Knapp, Victor, Article 77, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 562

²⁷⁹⁰ *Ibid.*, at 561

the contract date of performance before declaring the contract avoided and taking measures to reduce the loss arising out of the breach by making a cover purchase, reselling the goods or otherwise.²⁷⁹¹ It is argued that the mitigation rule is *lex specialis* in relation to the general rule requiring specific performance, and should prevail in those cases, except where a party's need for requiring specific performance is so strong as to outweigh the mitigation principle of Article 77.²⁷⁹²

The CISG does not expressly deal with the issue of contributory negligence in the assessment of the damages. Article 80 establishes the extent to which the non-performing party is excused from liability for non-performance due to the conduct of the aggrieved party. It provides that "a party may not rely on a failure of the other party to perform, to the extent that such failure was caused by the first party's act or omission." Thus, a party cannot rely on the other party's failure to the extent that he contributed to it. As Article 80 is placed in Part III, Chapter V, Section IV "Exemptions", it raises the question whether Article 80 governs only problems of exemption from liability or it modifies all of the remedial provisions of the Convention, as if it had been placed in Part III, Chapter I "General Provisions". The legislative history of Article 80 links it closely to the rules on exemption in Article 79.²⁷⁹³ However, this rule is generally seen as the application of the principle of good faith, since it is considered contrary to good faith that the aggrieved party should obtain total compensation when he, himself, failed to perform one of his obligations under the contract or the Convention.²⁷⁹⁴

Some view Article 80 as an all-or-nothing solution and argue that it is not suitable to deal with cases, where both parties have caused the non-performance, in an appropriate manner. Thus, it is argued that Article 80 should not, as a general rule, be applied directly to cases of joint responsibility, but the other provisions of the CISG should be applied to establish the mutual breach of the obligations by the parties, whereby one party's claim for compensation of this damage will have to be discounted by the percentage of his part in the causation of the non-performance by the other party.²⁷⁹⁵ Others argue that it is both natural and fair to allocate

²⁷⁹¹ *Ibid.*, at 567

²⁷⁹² Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 462

²⁷⁹³ *Ibid.*, at 495

²⁷⁹⁴ Tallon, Denis, Article 80, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 598-600; Huber, Peter, & Alastair Mullis, *The CISG: A New Textbook for Students and Practitioners*, Sellier European Law Publishers, 2007, at 267-268

²⁷⁹⁵ Huber, Peter, & Alastair Mullis, *The CISG: A New Textbook for Students and Practitioners*, Sellier European Law Publishers, 2007, at 267-268; China International Economic & Trade Arbitration Commission [CIETAC], 9 August 2002, available at <http://cisgw3.law.pace.edu/cases/020809c1.html>: This approach was apparently adopted by the arbitral tribunal. In the case, the seller made incomplete deliveries, but claimed to be exempt from liability as the incomplete deliveries were caused partly by natural disaster in the seller's region and partly by the buyer's issuance of a non-contractual letter of credit. Regarding the first cause, the tribunal considered that the seller still had the duty to purchase substitute goods from others, and could have overcome the alleged event of force majeure by acquiring substitute goods. Therefore, the tribunal held that the seller was not exempted of liability. As to the second cause, the tribunal found that when issuing the letter of credit, the buyer did not perform its duty in strict compliance with the contract, and it brought some inconvenience for performance of the contract since it was a "precondition for the seller to deliver the goods, but not the necessary condition for the seller to prepare the goods." The tribunal held that the buyer shall bear part of the liability for non-full performance of the contract. Because the buyer had some liability for the non-fully-performance of the contract, and the buyer's evidence was not sufficient to prove its indirect loss, the tribunal did not sustain the buyer's claim for indirect loss, which, in the buyer's view, arose from the buyer's failure to deliver the goods to its customers in accord with the contracts, resulting in reputation damages and lost profits.

losses between the parties according to their contribution, since there are sufficient grounds for using this method in the CISG itself under the causation requirement and Article 80, or alternatively, Article 7.4.7 of the UNIDROIT Principles can be used to supplement the CISG in this respect.²⁷⁹⁶ It is also argued that since Article 80 only indicates that the causes must be apportioned, but does not specify how, two methods are conceivable. The first method, which is considered as being the most in harmony with the spirit and the letter of the text, consists in the apportionment of the causes depending on their degree to objective causation, and part of the damage must be imputed to the aggrieved party if it was highly probable that his behavior would entail the failure to perform. The second method consists of comparing the gravity of the respective behaviors of the parties, thus partially reverting to the notion of fault or to the concept of contributory negligence. Since the Convention has set the notion of fault aside, the first method of evaluation is seen as the better one, but not to be applied strictly: the judge should consider that “the more reprehensible the behavior of one party is, the more likely it is to have played an important causal role in the other party's failure to perform” thereby including tortious behavior in the evaluation as part of the good faith requirement, as long as the tort has a connection with the failure to perform.²⁷⁹⁷

In general, it can be said that the prevailing view of legal writers is that apportionment of the loss must be possible under the wording of Article 80, since the second part of the provision provides that relying on the failure to perform is only excluded “to the extent” that such failure was caused by the aggrieved party's behavior.²⁷⁹⁸ However, it is also pointed out that in the absence of any precise indication in the text of Article 80, the judge will have a quasi-discretionary power and will eventually be led to seek guidance in the familiar rules of his own law in order to determine whether or not to award a lesser amount as damages to the aggrieved party through the “apportionment” of the causes between the parties and the extent

²⁷⁹⁶ Saidov, Djakhongir, Causation in Damages: The Convention on Contracts for the International Sale of Goods, the UNIDROIT Principles of International Commercial Contracts, the Principles of European Contract Law, *Review of the Convention on Contracts for International Sale of Goods (CISG): 2004-2005*, *Pace International Law Review*, München: Sellier, 2006, at 250-151

²⁷⁹⁷ Tallon, Denis, Article 80, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 598-600; It is similarly argued that in case where the failures of the two parties are so closely interwoven that their effects cannot be delimited and attributed to the breach of contract which is the result of that situation, it is appropriate in these cases to reduce quantitatively the damages. Enderlein, Fritz & Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary*, Oceana Publications, 1992, at 338

²⁷⁹⁸ Schwenzer, Ingeborg & Simon Manner, *The Pot Calling the Kettle Black: The Impact of the Non-Breaching Party's (Non-) Behaviour on its CISG-Remedies*, in Camilla B. Andersen & Ulrich G. Schroeter (eds.), *Sharing International Commercial Law across National Boundaries: Festschrift for Albert H. Kritzer*, Wildy, Simmonds & Hill Publishing, 2008, at 476-477

to which party in breach is exempted.²⁷⁹⁹ It should be noted that the national courts have not made such an apportionment with express reference to Article 80 of the CISG.²⁸⁰⁰

Finally, the CISG does not deal with penalty clauses, liquidated damages clauses and exemption or limitation of liability clauses. Although there is general agreement that the Convention does not exclude such clauses and the parties may include such clauses in their contracts pursuant to Article 6, which incorporates the principle of contractual freedom to derogate from the Convention, their validity and effects are outside the scope of the Convention.²⁸⁰¹ If the parties have included such a clause in their contract governed by the CISG, the validity of the clause will depend on the applicable national law pursuant to Article 4 (a) of the CISG, which states that the Convention is not concerned with the validity of any of the provisions of the contract. The question of judicial reduction of the sum stipulated under the penalty or liquidated damages clauses is to be determined by the applicable national law, because this question is attached to and interwoven with the question of validity.²⁸⁰²

The remedy of damages is located in the final Section of Chapter 7 of the UNIDROIT Principles. Article 7.4.1 provides that any non-performance gives the aggrieved party a right to damages either exclusively or in conjunction with any other remedies except where the non-performance is excused under the Principles. The Official Comments state that “This Article establishes the principle of a general right to damages in the event of non-performance, except where the non-performance is excused under the Principles, as in the case of force majeure (see Article 7.1.7) or of an exemption clause (see Article 7.1.6). Hardship (see Article 6.2.1 et seq.) does not in principle give rise to a right to damages.”²⁸⁰³ Under Article 7.4.1, the existence of the right of action for damages is based on proof of non-performance, not on proof of harm and, thus, where the aggrieved party has not suffered any

²⁷⁹⁹ Tallon, Denis, Article 80, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 598-600; *Arbitration Tribunal of Bulgarian Chamber of Commerce & Industry Case No. 56/1995 of 24 April 1996*, available at <http://cisgw3.law.pace.edu/cases/960424bu.html> : The arbitral tribunal found that the seller and the buyer were joint contributors to the harm. According to the tribunal, in the absence of any rules on contributory negligence in CISG, the question was settled in conformity with the law applicable by virtue of the rules of private international law pursuant to Article 7(2) of the CISG, which led to the application of Bulgarian law, which provides that if the default is caused by circumstances for which the creditor is responsible, the court must reduce the amount of the damages or relieve the debtor from responsibility. Considering the factual situation, the tribunal allowed the claim partially, only for the amount of 50%.

²⁸⁰⁰ Neumann, Thomas, *Shared Responsibility under Article 80 CISG*, *Nordic Journal of Commercial Law* (2/2009), at 11 (noting that a number of court cases, in which the promisor's failure to perform is caused solely by the promisee, have been decided with express reference to Article 80, but there are arbitral awards where an apportionment has been carried out without any reference to the legal basis for doing so, or with multiple references to provisions other than Article 80 of the CISG)

²⁸⁰¹ Blase, Friedrich, & Philipp Höttler, *Claiming Damages in Export Trade, On Recent Developments of Uniform Law, Review of the Convention on Contracts for the International Sale of Goods (CISG): 2004-2005*, *Pace International Law Review*, Sellier European Law Publishers, 2006, at 57

²⁸⁰² Mohs, Florian, & Bruno Zeller, *Commentary: Penalty and Liquidated Damages Clauses in CISG Contracts Revisited*, *Mealey's International Arbitration Report*, 21-6 (June 2006), at 2 fn. 10; *Diepeveen-Dirkson BV v Nieuwenhoven Vichandel GmbH Gerechtshof Arnhem*, 22 August 1995, English abstract at <http://www.unilex.info/case.cfm?pid=1&do=case&id=156&step=Abstract>; CIETAC award of 6 February 1997 at <http://cisgw3.law.pace.edu/cases/970206c1.html>; Award of 10 January 1998 of the Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry at <http://cisgw3.law.pace.edu/cases/980110r1.html>

²⁸⁰³ Official Comment 1 to Article 7.4.1 of the UNIDROIT Principles

harm as a result of the non-performance, the aggrieved party may nevertheless have a right to recover damages.²⁸⁰⁴

Article 7.4.2 of the UNIDROIT Principles provides the principle of the aggrieved party's entitlement to full compensation, and affirms the need for a causal link between the non-performance and the harm. It provides that the aggrieved party is entitled to full compensation for harm sustained as a result of the non-performance. Article 7.4.2 does not define the concept of full compensation, but provides that the harm that the aggrieved party has sustained includes both any loss which it suffered and any gain of which it was deprived. Due to its similarity to the first sentence of Article 74 of the CISG, and the reference to that article in the Official Comment, it is possible to conclude that full compensation means the making good of losses suffered and compensation for profits lost, i.e. expectation (positive) interest.²⁸⁰⁵ The Official Comment explains that the notion of loss suffered must be understood in a wide sense, such as a reduction in the aggrieved party's assets or an increase in its liabilities, and "the loss of profit or, as it is sometimes called, consequential loss, is the benefit which would normally have accrued to the aggrieved party if the contract had been properly performed."²⁸⁰⁶ It is argued that there are two options available to a decision maker seeking to provide an aggrieved party with full compensation. The first is to award the aggrieved party the difference in value between what it received and what it expected to receive had the contract been performed according to its terms. The second is the cost of putting the aggrieved party in the position which it would have occupied had the contract been performed according to its terms.²⁸⁰⁷

Article 7.4.2 explicitly requires the decision maker to take into account any gain to the aggrieved party resulting from its avoidance of cost or harm. The Official Comment to Article 7.4.2 states that the aggrieved party must not be enriched by damages for non-performance.²⁸⁰⁸ Thus, it is not possible for the aggrieved party to recover punitive damages. In awarding loss profits as damages, the decision maker shall take into account net profit as opposed to gross profit. Moreover, the aggrieved party may not escape from a bad bargain by recovering its wasted expenditure, where it would not have recovered that expenditure had the contract been performed according to its terms, since this would reverse the risk allocation agreed by

²⁸⁰⁴ It is argued that, in a case where there is non-performance but no harm, the decision maker can only make a declaratory judgment or award "nominal damages". Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 868. However, an express provision enabling the decision maker to award nominal damages was included in early drafts: e.g. UNIDROIT (1986) Study L — Doc 36, at 6: Article 3 (Nominal damages) "The judge may award nominal damages when the amount of loss cannot be sufficiently proved."; but that article was later discarded in UNIDROIT (1991) Study L — Doc 49, at 5.

²⁸⁰⁵ Official Comment 2 to Article 7.4.2 of the UNIDROIT Principles; Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 873.

²⁸⁰⁶ Official Comment 2 to Article 7.4.2 of the UNIDROIT Principles.

²⁸⁰⁷ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 873-874 (also suggesting that in cases where the two measures can produce very different results, a decision maker should ordinarily grant damages assessed on a cost of cure basis where the aggrieved party seeks damages on this basis and should refuse to make such an award only where it is satisfied that the aggrieved party has no intention of carrying out the repair work and that the cost of the repair is completely disproportionate to the benefit likely to be obtained by carrying out the repair.)

²⁸⁰⁸ Official Comment 3 to Article 7.4.2 of the UNIDROIT Principles.

the parties and put the aggrieved party into a better position than he would have been in.²⁸⁰⁹ On these bases, the aggrieved party is able to combine a claim for loss of net profit with a claim to recover damages for any wasted expenditure, which is recoverable in the course of the performance of the contract, and there is no element of double recovery or enrichment in such a combination.²⁸¹⁰ The Official Comment also states that, in application of the principle of full compensation, regard is to be had to any changes in the harm, including its expression in monetary terms, which may occur between the time of the non-performance and that of the judgment.²⁸¹¹ Thus, it is argued that Article 7.4.2 entitles a decision maker, exercising its discretionary power, to assess the damages payable at the date of judgment rather than the date of breach, in a particular case.²⁸¹²

Article 7.4.3 (1) provides that compensation is due only for harm that is established with a reasonable degree of certainty. According to the Official Comments, both the occurrence and the extent of the harm, including harm which has not yet occurred, must be established by the aggrieved party with a reasonable degree of certainty.²⁸¹³ Article 7.4.3 (2) explicitly provides that compensation may be due for the loss of a chance in proportion to the probability of its occurrence. According to Article 7.4.3 (3), where the amount of damages cannot be established with a sufficient degree of certainty, the court is empowered to make an equitable quantification of the harm sustained, rather than refusing any compensation or awarding nominal damages thereby enabling the decision maker to avoid the all-or-nothing consequences.²⁸¹⁴ Article 7.4.3 complements the provision under Article 7.4.1, which implicitly presupposes a sufficient causal link between the non-performance and the harm. In the Official Comment to Art 7.4.3, reference is made to the fact that the harm must be a direct consequence of the non-performance, and it is stated the harm which is too indirect will usually also be uncertain as well as unforeseeable.²⁸¹⁵ While the questions of certainty of harm and sufficient causal link are related, it is suggested that the decision maker should first identify the harm with a reasonable degree of certainty and, then, consider the sufficiency of the causal link.²⁸¹⁶

Article 7.4.4 sets forth the principle of foreseeability as a limitation of recoverable damages, as found in Article 74 of the CISG. Article 7.4.4 provides that the non-performing party is liable only for harm which it foresaw or could reasonably have foreseen at the time of the conclusion of the contract as being likely to result from its non-performance. The Official Comment stresses the importance of allocation of risk under the contract in the application of the foreseeability test and states that “the non-performing party must not be saddled with

²⁸⁰⁹ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 875

²⁸¹⁰ *Ibid.*, at 876

²⁸¹¹ Official Comment 4 to Article 7.4.2 of the UNIDROIT Principles

²⁸¹² Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 876-877; However, Article 7.4.10 provides that, unless otherwise agreed, interest on damages for non-performance of non-monetary obligations accrues as from the time of non-performance.

²⁸¹³ Official Comment 2 to Article 7.4.3 of the UNIDROIT Principles

²⁸¹⁴ Official Comment 2 to Article 7.4.3 of the UNIDROIT Principles

²⁸¹⁵ Official Comment 3 to Article 7.4.3 of the UNIDROIT Principles

²⁸¹⁶ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 884

compensation for harm which it could never have foreseen at the time of the conclusion of the contract and against the risk of which it could not have taken out insurance.”²⁸¹⁷ Article 7.4.4 follows the example of the CISG and does not adopt the rule, which allows compensation even for harm which is unforeseeable when the non-performance is due to willful misconduct or gross negligence. Due to the absence of such a rule, the Official Comment states that a narrow interpretation of the concept of foreseeability is required, and the foreseeability relates to the nature or type of the harm but not to its extent, unless the extent is such as to transform the harm into one of a different kind.²⁸¹⁸ It is further stated that what was foreseeable is to be determined by reference to the time of the conclusion of the contract, and the test is what a normally diligent person could reasonably have foreseen as the consequences of non-performance in the ordinary course of things and the particular circumstances of the contract, such as the information supplied by the parties or their previous transactions.²⁸¹⁹

Article 7.4.5 of the UNIDROIT Principles, based on Article 75 of the CISG, provides for the concrete method of assessing damages in the case of termination. It provides that where the aggrieved party has terminated the contract and has made a replacement transaction within a reasonable time and in a reasonable manner it may recover the difference between the contract price and the price of the replacement transaction as well as damages for any further harm. The replacement transaction must generally have been entered into after the contract has been terminated with the exception of such cases that the non-performing party has made it clear that it will not perform its obligations under the contract. Moreover, the aggrieved party must have ‘made a replacement transaction’ with a third party, and demonstrate that it would not have entered into the transaction had it not been for the non-performance.²⁸²⁰ Where the aggrieved party has attempted to enter into a replacement transaction but these attempts prove to be unsuccessful, the aggrieved party cannot recover the cost of these negotiations under Article 7.4.5, but it may be able to recover them under Article 7.4.8 as expenses reasonably incurred in attempting to reduce the harm.

Article 7.4.6 incorporates the abstract method of calculation of damages and corresponds in substance to Article 76 of the CISG. Article 7.4.6 (1) provides that where the aggrieved party has terminated the contract and has not made a replacement transaction but there is a current price for the performance contracted for, it may recover the difference between the contract price and the price current at the time the contract is terminated as well as damages for any further harm. The current price for the performance of contract is defined in Article 7.4.6 as the price generally charged for goods delivered or services rendered in comparable circumstances at the place where the contract should have been performed or, if there is no current price at that place, the current price at such other place that appears reasonable to take as a reference. Both Article 7.4.5 and Article 7.4.6 establish only a minimum right of recovery, in the sense of presumptions which may facilitate the task of the aggrieved party, and operate alongside the general rules applicable to the proof of the existence and of the amount of the harm. The aggrieved party is allowed to obtain damages for additional harm

²⁸¹⁷ Official Comment to Article 7.4.4 of the UNIDROIT Principles

²⁸¹⁸ Ibid.

²⁸¹⁹ Ibid.

²⁸²⁰ Official Comment 1 to Article 7.4.5 of the UNIDROIT Principles states that “The presumption comes into play only if there is a replacement transaction and not where the aggrieved party has itself performed the obligation which lay upon the non-performing party ... Nor is there replacement, and the general rules will apply, when a company, after the termination of a contract, uses its equipment for the performance of another contract which it could have performed at the same time as the first (“lost volume”).”

which it may have sustained as a consequence of termination, by proving that it has suffered such harm.²⁸²¹

Article 7.4.7 of the UNIDROIT Principles provides that where the harm is due in part to an act or omission of the aggrieved party or to another event as to which that party bears the risk, the amount of damages shall be reduced to the extent that these factors have contributed to the harm, having regard to the conduct of each of the parties. Article 7.4.7 is closely linked to Article 7.1.2, which corresponds to Article 80 of the CISG, and provides that a party may not rely on the non-performance of the other party to the extent that such non-performance was caused by the first party's act or omission or by another event for which the first party bears the risk. The Official Comment states that, in application of the general principle established by Article 7.1.2, Article 7.4.7 limits the right to damages to the extent that the aggrieved party has in part contributed to the harm.²⁸²² Essentially, the Official Comment to Article 7.1.2 states that when the Article applies, the relevant conduct does not become excused non-performance, but loses the quality of non-performance altogether.²⁸²³ Thus, in such cases, the aggrieved party is not able to invoke non-performance and may not avail itself of any of the remedies under Chapter 7 of the Principles. However, as explained by the Official Comment, Article 7.1.2 contemplates the possibility that one party's interference, which may also arise from an event the risk of which is expressly or impliedly allocated by the contract to that party, results only in a partial impediment to performance by the other party.²⁸²⁴ Thus, in such cases it will be necessary to decide the extent to which non-performance was caused by the first party's interference and, to that extent, the non-performing party will remain exposed to the remedies provided in Chapter 7 of the Principles. Accordingly, the interference of the aggrieved party will be taken into consideration at the stage of calculating damages and may result in a reduction in the damages payable to it under the specific provision of Article 7.4.7.²⁸²⁵

Under Article 7.4.7, the interference of the aggrieved party, which is considered as its contribution to the harm, may consist either in its own conduct or in an event for which it bears the risk. The conduct may take the form of an act or an omission. The Official Comment explains that most frequently such acts or omissions will result in the aggrieved party failing to perform one or another of its own contractual obligations, but they may equally consist in tortious conduct or non-performance of another contract.²⁸²⁶ As to the issue of apportionment of contribution to the harm, the Official Comment states that "The determination of each party's contribution to the harm may well prove to be difficult and will to a large degree depend upon the exercise of judicial discretion. In order to give some guidance to the court this Article provides that the court shall have regard to the respective behaviour of the parties. The more serious a party's failing, the greater will be its contribution to the harm."²⁸²⁷ Finally, the Official Comment seeks to distinguish Article 7.4.7 from the principle of mitigation under Article 7.4.8 on the basis that Article 7.4.7 is concerned with the conduct of the aggrieved

²⁸²¹ Official Comment 2 to Article 7.4.5 and Official Comment 3 to Article 7.4.6 of the UNIDROIT Principles

²⁸²² Official Comment 1 to Article 7.4.7 of the UNIDROIT Principles

²⁸²³ Official Comment 1 to Article 7.1.2 of the UNIDROIT Principles

²⁸²⁴ Official Comment 2 to Article 7.1.2 of the UNIDROIT Principles

²⁸²⁵ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 737

²⁸²⁶ Official Comment 2 to Article 7.4.7 of the UNIDROIT Principles

²⁸²⁷ Official Comment 3 to Article 7.4.7 of the UNIDROIT Principles

party in regard to the cause of the initial harm, while Article 7.4.8 relates to that party's conduct subsequent thereto.²⁸²⁸

Article 7.4.8 of the UNIDROIT Principles incorporates the principle of mitigation, which can be found in Article 77 of the CISG. Article 7.4.8 (1) provides that the non-performing party is not liable for harm suffered by the aggrieved party to the extent that the harm could have been reduced by the latter party's taking reasonable steps. The Official Comment states that the purpose of this Article is to avoid the aggrieved party passively sitting back and waiting to be compensated for harm, which it could have avoided or reduced. Any harm which the aggrieved party could have avoided by taking reasonable steps will not be compensated.²⁸²⁹ It is explained that the steps to be taken by the aggrieved party may be directed either to limiting the extent of the harm, above all when there is a risk of it lasting for a long time if such steps are not taken, or to avoiding any increase in the initial harm.²⁸³⁰ Article 7.4.8 (2) provides that the aggrieved party is entitled to recover any expenses reasonably incurred in attempting to reduce the harm. According to the Official Comment, the reduction in damages to the extent that the aggrieved party has failed to take the necessary steps to mitigate the harm must not however cause loss to that party.²⁸³¹ Thus, reasonable expenses incurred by the aggrieved party can be recoverable even if the relevant actions failed to mitigate the loss or had the effect of increasing the total loss.²⁸³²

Article 7.4.13 of the UNIDROIT Principles applies to penalty and liquidated damages clauses. Article 7.4.13 (1) provides that where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual harm. In the Official Comment, it is stated that "this article gives an intentionally broad definition of agreements to pay a specified sum in case of non-performance, whether such agreements be intended to facilitate the recovery of damages (liquidated damages according to the common law) or to operate as a deterrent against non-performance (penalty clauses proper), or both."²⁸³³ In view of their frequency in international contract practice, Article 7.4.13 acknowledges the validity of any clauses providing that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, and allows the aggrieved party to recover that sum irrespective of its actual harm.²⁸³⁴ Article 7.4.13 also enables the parties to specify the amount

²⁸²⁸ Official Comment 4 to Article 7.4.7 of the UNIDROIT Principles

²⁸²⁹ Thus, the aggrieved party, who fails to take reasonable steps to limit the extent of the harm, or to avoid any increase in the initial harm, will not be entitled to recover damages in respect of the harm which flows from its failure to take these reasonable steps. It is also argued that the text of Article 7.4.8 does not allow the decision maker to exercise its discretionary power to apportion the loss, when it has been established that the aggrieved party has failed to take reasonable steps to reduce the harm, since the text provides that the non-performing party "is not liable" for the harm that is attributable to the failure to take reasonable steps. This is seen in contrast with the text of Article 7.4.7, where the amount of damages shall be reduced "to the extent that" the aggrieved party has contributed to the harm, having regard to the conduct of each of the parties. Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 903

²⁸³⁰ Official Comment 1 to Article 7.4.8 of the UNIDROIT Principles

²⁸³¹ Official Comment 2 to Article 7.4.8 of the UNIDROIT Principles

²⁸³² Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 904

²⁸³³ Official Comment 1 to Article 7.4.13 of the UNIDROIT Principles

²⁸³⁴ Official Comment 2 to Article 7.4.13 of the UNIDROIT Principles

of recoverable damages at the time of contracting, thereby determining or limiting the recoverable sum as damages in case of non-performance. The aggrieved party can only recover the specified sum and cannot resort to an action in damages for the purpose of recovering the full extent of its loss, where the specified sum is lower than the actual loss which it has suffered.²⁸³⁵

In order to prevent the possibility of abuse to which such clauses may give rise, Article 7.4.13 (2) provides that, notwithstanding any agreement to the contrary, the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances. According to the Official Comment, a sum is likely to be grossly excessive if it “would clearly be so to any reasonable person”.²⁸³⁶ Since it is provided that whether or not the sum is “grossly excessive” will be determined by comparing the sum against the “harm resulting from the non-performance”, it is argued that the actual harm is to be assessed at the time of the non-performance, not the time at which the contract was concluded, so that it should not be necessary for the aggrieved party to establish that the non-performing party could reasonably have foreseen the harm at the time of the conclusion of the contract.²⁸³⁷ The Official Comment does not discuss the content of the “other circumstances” in the qualification of an agreed sum as grossly excessive. It is suggested that the decision maker should have regard to the equality of the bargaining power of the parties and the extent to which they were legally advised.²⁸³⁸

Even where the conditions for reduction of agreed sum are established in a given case, the decision maker has discretion to reduce that sum, as a result of the use of word “may” rather than “shall” in relation to the power of the decision maker to reduce the agreed sum to a “reasonable amount” under Article 7.4.13. Moreover, the agreed sum may only be reduced, but cannot entirely be disregarded by the decision maker to award damages corresponding to the exact amount of the harm.²⁸³⁹ This suggests that “reasonable amount” is not necessarily to be identified with the actual harm which the aggrieved party has suffered and it can be higher than the actual harm. The decision maker enjoys a substantial discretion in fixing the amount that is reasonable. However, the agreed sum may not be increased, under Article 7.4.13, where the agreed sum is lower than the harm actually sustained. In such cases where the agreed sum has the effect of limiting the compensation, the non-performing party may not be entitled to rely on the term in question, if the conditions laid down under Article 7.1.6 on exemption or limitation of liability clauses are satisfied. Thus, such a clause that limits one party's liability for non-performance cannot be invoked when it would be grossly unfair to do so, having regard to the purpose of the contract, particularly if the non-performance was the result of intentional or grossly negligent conduct.²⁸⁴⁰ In those cases, the decision maker will

²⁸³⁵ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 924

²⁸³⁶ Official Comment 3 to Article 7.4.13 of the UNIDROIT Principles

²⁸³⁷ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 925

²⁸³⁸ Ibid.

²⁸³⁹ Official Comment 3 to Article 7.4.13 of the UNIDROIT Principles

²⁸⁴⁰ Official Comment 4 and 5 to Article 7.1.6 of the UNIDROIT Principles; The Official Comment contains following illustration: “A enters into a contract with B for the building of a factory. The contract contains a penalty clause providing for payment of Australian dollars (AUD) 10,000 for each week of delay. The work is not completed within the agreed period because A deliberately suspends the work for another project which was more lucrative for it and in respect of which the penalty for delay was higher. The actual harm suffered by B as a

award the actual damages, due to the invalidity of the clause, and it may not modify the agreed sum under the relevant clause.²⁸⁴¹

Under the PECL, the rules on damages for non-performance are contained in Section 5 of Chapter 9. Article 9:501 (1) of the PECL provides that the aggrieved party is entitled to damages for loss caused by the other party's non-performance, which is not excused under Article 8:108. The Official Comment explains that it is not possible to recover damages for a breach which has caused the aggrieved party no loss, and the relevant section does not provide for nominal damages for a breach which has caused the aggrieved party no loss.²⁸⁴² Article 9:501 applies to all forms of failure in performance and does not require that the aggrieved party serve a notice to perform before it can recover damages for delay. The Official Comment emphasizes the need for a causal link between the non-performance and the loss, and states that the aggrieved party may not recover damages for loss not caused by the failure to perform.²⁸⁴³ Article 9:501 (2) provides that the loss for which damages are recoverable includes: (a) non-pecuniary loss; and (b) future loss which is reasonably likely to occur. According to the Official Comments, the latter type of loss is the loss expected to be incurred after the time damages are assessed and often takes the form of the loss of a chance. Accordingly, the decision maker is required to evaluate two uncertainties, namely the likelihood that future loss will occur and its amount.²⁸⁴⁴

Article 9:502 of the PECL provides that “The general measure of damages is such sum as will put the aggrieved party as nearly as possible into the position in which it would have been if the contract had been duly performed. Such damages cover the loss which the aggrieved party has suffered and the gain of which it has been deprived.” Thus, it is more explicit than 7.4.2 of the UNIDROIT Principles in its statement that what is protected is the expectation (positive) interest of the aggrieved party. Article 9:502 also combines the expectation interest basis of damages and the traditional rule of “damnum emergens” and “lucrum cessans” of Roman law, by stating that recoverable damages cover the loss which the aggrieved party has suffered and the gain of which it has been deprived.²⁸⁴⁵ The Official Comment makes it clear that any loss suffered by the claimant after a breach of contract must be offset by any gain to the claimant caused by the breach of contract.²⁸⁴⁶ Article 9:503 provides the foreseeability test in assessing the recoverable damages according to which the non-performing party is liable only for loss which it foresaw or could reasonably have foreseen at the time of conclusion of the contract as a likely result of its non-performance. In contrast to Article 7.4.4 of the UNIDROIT Principles and Article 74 of the CISG, Article 9:503 of the PECL provides that the foreseeability test cannot be invoked by the non-performing part as a limitation to the recoverable loss of the aggrieved party if the non-performance was intentional or grossly

result of the delay amounts to AUD 20,000 per week. A is not entitled to rely on the penalty clause and B may recover full compensation of the actual harm sustained, as the enforcement of that clause would in the circumstances be grossly unfair in view of A’s deliberate non-performance.”

²⁸⁴¹ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 765

²⁸⁴² Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 434

²⁸⁴³ *Ibid.*, at 435

²⁸⁴⁴ *Ibid.*, at 436

²⁸⁴⁵ *Ibid.*, at 438

²⁸⁴⁶ *Ibid.*, at 439

negligent. Unlike the UNIDROIT Principles which explicitly require that damages be proven with a reasonable degree of certainty, the only reference to the certainty requirement is in the Notes to Article 9:503 of the PECL, which state that most systems “generally require a sufficient degree of ‘certainty’ of loss’ in order to award damages, but this is not to be taken literally.”²⁸⁴⁷

Article 9:504 embodies the principle of contributory negligence, and provides that the non-performing party is not liable for loss suffered by the aggrieved party to the extent that the aggrieved party contributed to the non-performance or its effects. The Official Comment states that Article 9:504 embraces two distinct situations: (i) where the aggrieved party's conduct was a partial cause of the non-performance; and (ii) where the aggrieved party, though not in any way responsible for the non-performance itself, exacerbated its loss-producing effects by its behavior.²⁸⁴⁸ Article 9:504 of the PECL is also regarded as a particular application of the general rule set out in Article 8:101 (3), which corresponds to Article 7.1.2 of the UNIDROIT Principles and Article 80 of the CISG. According to the Official Comment, where the aggrieved party, though not in any way responsible for the non-performance, exacerbates its adverse effects, he cannot recover damages for the additional loss which results.²⁸⁴⁹

Article 9:505 incorporates the doctrine of mitigation, and provides that the non-performing party is not liable for loss suffered by the aggrieved party to the extent that the aggrieved party could have reduced the loss by taking reasonable steps, and the aggrieved party is entitled to recover any expenses reasonably incurred in attempting to reduce the loss. The Official Comment states that the aggrieved party may recover its full loss even if what at the time appears to be a reasonable step to reduce its loss in fact increases its full loss.²⁸⁵⁰ Articles 9:506 and 9:507 provide respectively concrete and abstract method of calculation of damages in case of termination. They are very similar to those provisions under the UNIDROIT Principles. A notable difference is that Article 9:507 does not contain a definition of the “current price”, which can be found under Article 7.4.6 (2) of the UNIDROIT Principles. Moreover, neither the UNIDROIT Principles nor the PECL include a special provision, similar to Article 76(1) of the CISG, that in cases where the aggrieved party has terminated the contract pursuant to taking the goods, the current price is determined according to the time of the taking of the goods, instead of the time of avoidance of the contract. The lack of such a provision in the restatements can be explained by their approach of dealing with all contractual situations, while the said provision aims at preventing the aggrieved buyers in sales contracts, who have taken the goods from benefitting from deferring avoidance tactically or speculatively, until such time as a more favorable current price emerges. Even so, the restatements more overtly impose good faith obligations, which would presumably disallow such tactical or speculative behavior.²⁸⁵¹

²⁸⁴⁷ Ibid., at 443

²⁸⁴⁸ Ibid., at 444

²⁸⁴⁹ Ibid.

²⁸⁵⁰ Ibid., at 446

²⁸⁵¹ Bruno Zeller, Art. 76 CISG-UP, and John Felemegas, Art. 76-PECL, in John Felemegas (ed.), *An International Approach to the Interpretation of the United Nations Convention on Contracts for the International Sale of Goods (1980) as Uniform Sales Law*, Cambridge University Press, 2006, at 226 and 485

Finally, Article 9:509 contains a provision on agreed payment for non-performance, which substantially corresponds to Article 7.4.13 of the UNIDROIT Principles. Under the PECL, the decision maker must disregard the loss actually suffered by the aggrieved party and must award neither more nor less than the sum fixed by the contract except where the sum is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances. The Official Comment to the PECL clarifies some aspects relating to the decision maker's power to reduce the specified sum, which are not so explicit in the UNIDROIT Principles. The Official Comment states that in deciding whether the stipulated sum is excessive the decision maker should have regard to the relationship between that sum and the loss actually suffered by the aggrieved party, as opposed to the loss legally recoverable within the foreseeability principle embodied in Article 9:503, and the computation of actual loss should take into account that element of the loss which has been caused by the unreasonable behavior of the aggrieved party itself, e.g. in failing to take reasonable steps in mitigation of loss.²⁸⁵² Moreover, the Official Comment expressly states that even though the decision maker has the power to reduce the agreed sum, when it is grossly excessive, this power has a limit in that the decision maker should respect the intention of the parties to deter default and therefore should not reduce the award to the actual loss, but has to fix an intermediate figure.²⁸⁵³

The Official Comment also takes into account that liquidated damages clauses may operate so as to limit the recovery of the aggrieved party, and states that in such a case, the aggrieved party can demand full compensation if it can prove that the existence of the conditions of Article 8:109, which provides that remedies for non-performance may be excluded or restricted unless it would be contrary to good faith and fair dealing to invoke the exclusion or restriction.²⁸⁵⁴ The Official Comment states that while Article 9:508 allows the court to reduce the amount of a stipulated payment for non-performance where this is grossly excessive, the converse is not true of limitations of liability under Article 8:109, which does not give the court a discretion simply to increase the liability but leaves it to be assessed in accordance with the rules in Chapter 9 of the PECL, as there is no valid limitation of liability.²⁸⁵⁵

c. Contracting Practices

The contractual clauses in the context of the transactions governed through legal uncertainty have the effect on the amount of recoverable damages for non-performance in various ways. They may subject the aggrieved party's claim for damages to a sequence of obligations, under which the aggrieved party's contractual obligations are explicitly recognized as a condition to the proper performance of obligations by the other party and, thus, when the aggrieved party, having violated its obligations, claims damages for the non-performance of the other party,

²⁸⁵² Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 454

²⁸⁵³ *Ibid.*

²⁸⁵⁴ *Ibid.*, at 385-386: It contains the following illustration, which closely resembles to that of the UNIDROIT Principles cited above: "The contract for the construction of a factory contains a penalty clause imposing liability for 10,000 francs per week for late completion. The work is completed late because the contractor has deliberately neglected the job in favor of another, more profitable one. If the loss suffered by the employer amounts to 20,000 francs per week, the latter may recover this amount despite the clause, as for the contractor to invoke it when it has deliberately disregarded the contract would be contrary to good faith and fair dealing".

²⁸⁵⁵ *Ibid.*, at 388

the decision maker is required to take into account the extent of contribution of the aggrieved party to the loss as a result of his failure to perform its own obligations.

In construction contracts, the main issue, which is related to the extent of recoverable damages, is the time for completion of the work. The construction contracts carefully specify the time for completion of the works, and the events, which entitle the contractor to an extension of time and/or the associated costs, thereby determining the extent of the damages recoverable by the employer for the contractor's delay. According to Sub-Clause 2.1 of the FIDIC Conditions, the Employer shall give the Contractor right of access to, and possession of, all parts of the Site. If the Contractor suffers delay and/or incurs cost as a result of a failure by the Employer to give any such right or possession, the Contractor shall give notice to the Engineer and shall be entitled to an extension of time for any such delay and payment of any such cost plus profit, which shall be included in the contract price. Thus, if the Employer fails to comply with this obligation, but later demands liquidated damages in case of contractor's failure to perform the contract on time, the time for completion will be determined by taking into account any extension of time for completion under Sub-Clause 8.4, which includes any delay, impediment or prevention caused by or attributable to the Employer and any payment of cost plus profit to the Contractor. On the other hand, Sub-Clause 2.1 also requires the consideration of contribution of the Contractor to the loss suffered by it as a result of the Employer's failure to give any such right or possession of the Site by providing that, "if and to the extent that the Employer's failure was caused by any error or delay by the Contractor, including an error in, or delay in the submission of, any of the Contractor's Documents, the Contractor shall not be entitled to such extension of time, Cost or profit."

The ICC model contract for the turnkey supply of an industrial plant contains a general provision on time schedules and cooperation. Article 7.2 declares that, the deadlines for performance by a party shall be automatically extended, to the extent they have been influenced by events, in which the other party (a) does not comply with the dates specified in the time schedule for its obligations; (b) does not perform in a timely manner any obligation upon which the performance of the other party's obligation is conditional; or (c) otherwise causes situations which delay the timely performance.

Such sequence of obligations can also be found in commercial agency contracts. In those contracts, the principal usually wants the agent to share the risk as to the financial status of customers in a foreign country, since the agent is in a better position to obtain necessary information for evaluating the financial risk involved in a sale. Thus, Article 10.1 of the ICC Model Commercial Agency Contract provides that the agent shall satisfy himself, with due diligence, of the solvency of customers whose orders he transmits to the principal. According to Article 10.1, the agent shall not transmit orders from customers of which he knows or ought to know that they are in a critical financial position, without informing principal in advance, and shall give reasonable assistance to the principal in recovering debts due. Pursuant to Article 16.2, the agent shall acquire the right to commission after full payment by the customers of the invoiced price. The terms of Article 16.2 regarding the time at which the right to commission is acquired are completely in favor of the principal. Thus, the principal does not run any risk of having to pay the agent a commission, which does not correspond to sums that he himself has received from the customer.²⁸⁵⁶ In this context, the failure of the agent to perform its duties under Article 10.1 seems only to serve as a ground for the principal

²⁸⁵⁶ Matray, Didier, Article 16, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract, A Commentary*, ICC Publication No. 512, Paris, 1993, at 67

to claim damages. However, the problem of solvency of customers is primarily that of the principal, who has many other means for protecting himself, such as insurance and letters of credit. Thus, Article 16.2 provides that in case the principal is insured against the risk of non-payment by his customers, the parties may agree that a commission be paid on the sums obtained by the principal from the insurer. In such cases, it is conceivable that the failure of the agent to perform its duties under Article 10.1 may serve as a ground for a reduction in the commissions to be paid on the sums paid by the insurer. Accordingly, Section 4 of Annex VI to the Model Contract offers a choice between two formulae for reduced commission in such cases: the agent may obtain either a half commission on the sums paid by the insurer or the whole commission on the sums paid by the insurer, after the deduction of the costs or expenses borne by the principal with reference to the non-payment.

Moreover, it is conceivable that the parties to a commercial agency contract may agree on the formula of the acquisition of the agent's entitlement to commission as from acceptance of the order by the principal, which is more balanced with regard to the interests of both parties, since it leaves the principal with the possibility of refusing orders, while the agent is entitled to commission once the order is accepted by the principal even if such an order was not paid for by the customer. In such cases, the failure of the agent to perform such duties as defined under Article 10.1 of the ICC Model Commercial Agency Contract may directly serve as limiting the extent of liability of the principal for its failure to pay commissions to which the agent is entitled.²⁸⁵⁷

The contracting parties may also approach to the issue of mitigation of harm arising from non-performance, by providing a sequence of obligations, which needs to be observed after non-performance by one of the parties, and affects the extent of recoverable loss. Such contractual clauses determine the reasonableness of the measures, which need to be taken by the aggrieved party, to mitigate the harm, and failure to follow the measures specified by the contract renders his actions unreasonable, regardless of whether such actions would be deemed reasonable under the applicable default rules. Under such a clause, the aggrieved party is obliged to take those specified measures, after the other party fails to perform its obligations properly, and failure of the aggrieved party to do so becomes a limitation to the recoverable sum to be obtained as damages for non-performance.

This approach can be observed in construction contracts with regard to the liability of the contractor for defective performance. Sub-Clause 11.2 of the FIDIC Conditions provides that the Contractor shall execute, at its own risk and cost, all work required to remedy defects or damage, as may be notified by the Employer on or before the expiry date of the defects notification period for the works, if and to the extent that the work is attributable to: (a) any design for which the Contractor is responsible, (b) plant, materials or workmanship not being

²⁸⁵⁷ It should be noted that, in view of the difficulty to prove, in a specific case, that the agent has acted negligently under Article 10.1, the Model Contract provides the option for the parties to agree on *del credere* agent assuming the risk with regard to the solvency of the customers. Annex V to the Model Contract defines a *del credere* obligation as the agent's undertaking to reimburse to the principal the total or partial amount of the unpaid sums that the principal is entitled to receive from customers and which have not been paid for reasons for which the principal is not responsible. Annex V provides different options for the limitation of the agent's liability for unpaid sums, taking into account that it would be against good faith or mandatory national rules on *del credere* to shift the whole risk of non-payment on agent. The commentary advises that if the payment of the customer is to be warranted, the clause should cover the full amount or the major part of it, but only for specific customers, while if the parties only wish to increase the agent's diligence in choosing customers, the clause should cover all customers for a limited percentage of the loss. Bortolotti, Fabio, Article 10, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract, A Commentary*, ICC Publication No. 512, Paris, 1993, at 46

in accordance with the Contract, or (c) failure by the Contractor to comply with any other obligation.²⁸⁵⁸ Sub-Clause 11.7 provides that the Contractor shall have such right of access to the Works as is reasonably required in order to comply with this Clause, except as may be inconsistent with the Employer's reasonable security restrictions. Thus, the Employer cannot simply rectify any defect itself or by means of a third party and then seek to recover the costs from the Contractor. It seems that the Employer's failure to comply with those specified duties, whether by refusing to allow the Contractor to carry out the repairs or by failing to give notice of the defects, will limit the amount of damages to an amount, which it would have cost the Contractor to remedy the defects.²⁸⁵⁹

Pursuant to Sub-Clause 11.4 of the FIDIC Conditions, only when the Contractor fails to remedy the defect or damage neither within a reasonable period of time nor by the date fixed by the Employer after that period and this remedial work was to be executed at the cost of the Contractor, the Employer may, at his option; (a) carry out the work himself or by others, in a reasonable manner and at the Contractor's cost, but the Contractor shall have no responsibility for this work, and the Contractor shall pay to the Employer the costs reasonably incurred by the Employer in remedying the defect or damage; (b) require the Engineer to agree or determine a reasonable reduction in the contract price; or (c) if the defect or damage deprives the Employer of substantially the whole benefit of the Works or any major part of the Works, terminate the Contract as a whole, or in respect of such major part which cannot be put to the intended use.

Article 31 of the ICC model contract for the turnkey supply of an industrial plant provides, in general terms, a similar sequence of obligations in remedying the defective performance by the Supplier. Article 31.4 (2) declares that if the Purchaser has not notified the Supplier of a defect as required by the provisions of Article 31, it forfeits its rights to have the defect made good in accordance with Article 31.1, which obliges the Supplier to remedy the defect. Even so, Article 31.6 entitles and obliges the Purchaser to apply all necessary measures to prevent or limit damage, if a defect requires immediate action due to the risk of resultant damage, and the Supplier cannot make immediately good the defect.

A similar sequence of obligations, which imposes certain duties on the aggrieved party for the period after breach, and the disruption of which affects the extent of its recoverable loss, can be found in the ICC Model Mergers & Acquisitions Contract. According to Article 10, the buyer is required to give claim notice to the seller as soon as practicable, whenever the buyer becomes aware that an event has occurred from which there may arise a liability of the seller due to the breach of a warranty. If the buyer fails to give claim notice timely, the seller will

²⁸⁵⁸ It is also provided in the same sub-clause that if and to the extent that such work is attributable to any cause other than those set out under Sub-Clause 11.2, the Contractor shall be notified promptly by the Employer, and the variation procedure shall apply. According to Sub-Clause 13.1, "Each Variation may include: (a) changes to the quantities of any item of work included in the Contract (however, such changes do not necessarily constitute a Variation), (b) changes to the quality and other characteristics of any item of work, (c) changes to the levels, positions and/or dimensions of any part of the Works, (d) omission of any work unless it is to be carried out by others, (e) any additional work, Plant, Materials or services necessary for the Permanent Works, including any associated Tests on Completion, boreholes and other testing and exploratory work, or (f) changes to the sequence or timing of the execution of the Works."

²⁸⁵⁹ Glover, Jeremy, Simon Hughes, & Christopher Thomas, *Understanding the New FIDIC Red Book: A Clause by Clause Commentary*, Sweet & Maxwell, 2006, at 240; In *Pearce and High v Baxter*, (1999) BLR 101 (CA), it was held that when a contractor is denied the right to repair defects itself as required by the contract, the contractor will not be liable for the full cost of repairs carried out by third parties, and the employer could not recover more than the amount which it would have cost the contractor to remedy the defects.

have no liability, to the extent that the seller demonstrates that the buyer's delay violated its obligation to use reasonable endeavors to mitigate loss. Article 11.4 provides that the seller shall have no liability under the contract unless it receives from the buyer a claim notice within the agreed period of time after closing.

Thus, contractual obligations of the aggrieved party, which needs to be performed not only before but also after the non-performance by the other party, are directly relevant to its claim for damages. If and to the extent that the aggrieved party fails to perform those contractual duties, the liability of the non-performing party for damages will be limited in a manner similar to the application of the rules relating to the causation, or the aggrieved party's contribution to or mitigation of loss under the national legal systems and the international instruments.

Moreover, the contracts sometimes allocate to a party the risks of certain events other than the breach of its contractual obligations, which may contribute to its harm arising from the other party's non-performance thereby limiting the extent of its recoverable damages for non-performance. Under the FIDIC Conditions, the risk of costs and delays in the works arising from the actions of Engineer, any other contractors, and the personnel of any legally constituted public authorities are allocated to the Employer. Sub-Clause 1.9 entitle the Contractor to an extension of time for completion and payment of any associated cost plus profit, in the event that the Engineer fails to issue a necessary drawing or instruction within a reasonable time after the Contractor's notice to the Engineer. However, Sub-Clause 1.9 declines extension and payment to the extent that the Engineer's failure was caused by any error or delay by the Contractor. Furthermore, Sub-Clause 8.8 of the FIDIC Condition allows the Engineer at any time to instruct the Contractor to suspend progress of part or all of the works. During such suspension, the Contractor shall protect, store and secure such part or the Works against any deterioration, loss or damage. According to Sub-Clause 8.9, if and to the extent that the cause of suspension is notified by the Engineer and is not the responsibility of the Contractor, the Contractor shall be entitled to an extension of time for any such delay, if completion is or will be delayed, and payment of any cost, which shall be included in the contract price. However, the Contractor shall not be entitled to an extension of time for, or to payment of the cost incurred in making good the consequences of the Contractor's faulty design, workmanship or materials, or of the Contractor's failure to protect, store or secure in accordance with Sub-Clause 8.8. Under Sub-Clause 4.6 with regard to the duty of cooperation of the Contractor, the Contractor shall, as instructed by the Engineer, allow appropriate opportunities for carrying out work to the Employer's personnel, any other contractors, and the personnel of any legally constituted public authorities. If the Contractor complies with this duty of cooperation, any such instruction of the Engineer shall constitute a variation of time for completion and/or contract price to the extent that it causes the Contractor to suffer delays and to incur unforeseeable costs.

Under Sub-Clause 17.2 of the FIDIC Conditions, the Contractor is required to take full responsibility for the care of the works, goods or contractor's documents from the commencement date until the taking-over certificate is issued for the works. If any loss or damage happens to the works, goods or contractor's documents, other than due to "Employer's Risks", the Contractor must rectify this loss or damage at its cost, so that the works, goods or contractor's documents conform to the contract. According to Sub-Clause 17.3, "Employer's Risks" are generally events or circumstances over which neither party will have any control (e.g. war, hostilities and the like) or events or circumstances caused by the

Employer, directly or indirectly.²⁸⁶⁰ If the loss or damage occurs due to an Employer's Risk, the Contractor must rectify this loss or damage to the extent required by the Employer or the Engineer requires rectification, and the Contractor may be entitled to an extension of time and to any cost if it suffers delay and incurs cost in the performance of the contract. Sub-Clause 17.4 (b) of the FIDIC Conditions entitle the Contractor to recover profit in addition to the cost of rectification in two cases of loss or damage due to the Employer's Risk: (1) use or occupation by the Employer, and (2) design of any part of the Works by the Employer. In those two cases, there is Employer's breach of contract and the Contractor is entitled to recover his profit, whereas in the other cases the Employer does not have the control of the circumstances resulting in loss and, there is a further sharing of risk by the Contractor, by his giving up an entitlement to profit.²⁸⁶¹

The penalty or liquidated damages clauses are common in international contracts, yet the expressions "liquidated damages" and "penalty" are often used indiscriminately in practice.²⁸⁶² The purpose of those clauses varies depending on the choice of parties. They aim at fixing in advance the damages payable in the event of non-performance, limiting a non-performing party's liability, or providing a means of pressure on the debtor so as to coerce him into performing his obligation. They are particularly common in contracts for the performance of continuing obligations of a recurrent and largely unchanging nature, contracts for major projects with the characteristics of complex long-term contracts, as well as construction and large industrial projects.²⁸⁶³ Moreover, ease or difficulty in proving breach of the relevant obligation appears to play an important role in the insertion of a penalty or liquidated damages clause. It has been observed that such clauses are more appropriate for obligations to achieve a specific result than for obligations of best efforts.²⁸⁶⁴ Finally, in the contracting practice, a liquidated damages clause is frequently inspired by the obligor as a means for him to limit his liability.²⁸⁶⁵ Under such a clause, the recoverable loss is limited to a given ceiling or capped by a global ceiling.

Under most of the construction contracts, if a contractor goes beyond the stipulated time, he becomes liable to pay liquidated damages or penalty for late completion. Sub-Clause 8.7 of the FIDIC Conditions provides the liquidated damages in case of contractor's failure to perform the contract on time. If the Contractor fails to complete the works by the time for completion, with any extension under Sub-Clause 8.4, the Contractor shall pay delay damages

²⁸⁶⁰ Seppälä, Christopher R., *FIDIC's New Standard Forms of Contract – Risks, Force Majeure, Claims and Termination*, *International Business Law Journal*, (2000), at 1013

²⁸⁶¹ *Ibid.*, at 1016

²⁸⁶² Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 344; These expressions may affect the judicial decisions determining whether the clause in question will be found valid or invalid under common law, but it should be noted that the decision maker is not bound by the terminology chosen by the parties.

²⁸⁶³ Cremades, Bernardo M., *Liquidated Damages, Penalty Clauses and Punitive Damages within International Contracts*, *International Business Law Journal*, (2002), at 330

²⁸⁶⁴ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 332; Report of the Secretary-General: Liquidated Damages and Penalty Clauses (II) (A/CN.9/WG.2/WP.33), 12 February 1981, Yearbook of the United Nations Commission on International Trade Law, 12 (1981), at 39-40

²⁸⁶⁵ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 339; Report of the Secretary-General: liquidated damages and penalty clauses (A/CN.9/161), Yearbook of the United Nations Commission on International Trade Law, 10 (1979), at 41

to the Employer for this default. The delay damages shall be the sum stated in the contract data, which shall be paid for every day, which shall elapse between the relevant time for completion and the date stated in the taking-over certificate. However, the total amount due under this Sub-Clause shall not exceed the maximum amount of delay damages stated in the contract data. The liquidated damages under Sub-Clause 8.7 highlights the function of limitation to liability for delay by specifying an overall maximum amount and by providing that these delay damages shall be the only damages due from the Contractor for such default, other than in the event of termination by the Employer prior to completion of the works. It is also made clear that these damages shall not relieve the Contractor from his obligation to complete the works, or from any other duties, obligations or responsibilities which he may have under the contract. This last stipulation reflects the approach of some civil law systems, which distinguishes between a penalty imposed specifically for non-performance and a penalty clause relating to delay or defective performance, and allows combination of penalty with a right to claim proper performance only in the latter category.²⁸⁶⁶

According to Article 29.1 of the ICC model contract for the turnkey supply of an industrial plant, if delivery of the equipment occurs later than specified in the time schedules, and provided such delay is neither the result of force majeure nor the result of circumstances for which the purchaser is responsible, the purchaser shall be entitled to liquidated damages, which will be determined according to the length of delay, unless it is evident that the purchaser has suffered no loss due to delay. Under Article 29.2, the purchaser is entitled to liquidated damages irrespective of his loss if take-over of the plant occurs later than specified in the time schedule, and provided such delay is neither the result of force majeure nor the result of circumstances for which the purchaser is responsible. The cumulated amount of these liquidated damages is capped by Article 29.3 as a percentage of the contract price. Additionally, Article 29.4 provides that if the plant does not reach the guaranteed performance, but does reach the minimum performance levels at the latest time for taking-over specified in the time schedule, provided this lack of performance is neither the result of force majeure nor the result of circumstances for which the purchaser is responsible, the purchaser shall be entitled to liquidated damages, which will denote a percentage of the contract price and not exceed the maximum amount agreed by the parties. Article 32 provides that the remedy mentioned in Article 29 shall be the purchaser's sole remedy for supplier's delay and failure to reach the guaranteed performance.

International contracts commonly contain clauses limiting the scope of warranty or liability. These clauses allow the obligor to discard certain risks, or make them foreseeable and bearable.²⁸⁶⁷ In view of the uncertainty of the remedies granted under the applicable default rules, many contracts exempt the obligor from any liability for consequential damages by

²⁸⁶⁶ Article 1229 of the French Civil Code; Sections 340 and 341 of the German Civil Code; The UNCITRAL Secretariat's report on liquidated damages and penalty clauses states that, despite the differences between the approaches of national legal systems to the issue, the contracting practices clearly suggest that a possible reconciliation of these apparently different approaches may be found through contractual interpretation by determining the function contemplated by the parties as being served by the agreed sum i.e. either as a substitute for performance (no cumulative enforcement of penalty and performance), or as stimulation of proper performance and compensation for loss occurring between the time proper performance is due and it is actually rendered (cumulative enforcement permissible). Report of the Secretary General: Liquidated Damages and Penalty Clauses (II) (A/CN.9/WG.2/WP.33), Yearbook of the United Nations Commission on International Trade Law, 12 (1981), at 37

²⁸⁶⁷ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 351

listing various types of such damages, including loss of profit, cost of replacement supplies, damages caused to goods other than supplied, and claims by third parties.²⁸⁶⁸ Some clauses also envisage and exempt liability for unforeseeable losses. Usually, the clauses make it clear that the liability will not be limited or exempted in case of fraud or willful misconduct or some other specific event.²⁸⁶⁹ For example, Article 32.2 of the ICC model contract for the turnkey supply of an industrial plant excludes any liability for any indirect and consequential damages, such as but not limited to loss of profit, production, or contracts, and declares that this limitation of liability shall not apply in case of fraud or willful misconduct.

Sub-Clause 17.6 of the FIDIC Conditions provide that, neither party is liable to the other party for loss of use of any works, loss of profit, loss of any contract or for any indirect or consequential loss or damage which may be suffered by the other party in connection with the contract, other than as specifically provided in other clauses.²⁸⁷⁰ In addition to that, Sub-Clause 17.6 provides that the total liability of the Contractor to the Employer, under or in connection with the Contract other than under certain sub-clauses²⁸⁷¹, shall not exceed the sum resulting from the application of a multiplier (less or greater than one) to the accepted contract amount, as stated in the contract data, or (if such multiplier or other sum is not so stated), the accepted contract amount. Sub-Clause 17.6 excludes these limitations to liability in any case of fraud, deliberate default or reckless misconduct by the defaulting party.

In some contracts, the degree of limitation of liability for non-performance and, thus, the recoverable damages directly results from the parties' risk allocations as to such events that may lead to the non-performance by one of the parties. In share purchase agreements, the parties' risk sharing with regard to the facts covered by the representation or warranty determines how and to what extent the knowledge available to the buyer can affect the buyer's right to be compensated for breach of representation or warranty, particularly where a due diligence investigation has been made. In most of the cases, the parties agree on an autonomous meaning of "representations" and "warranties", independent of their legal meanings under national legal systems, and they expressly provide in the contract the legal consequences of a breach of representation or warranty. These representations and warranties concern the correctness of the target company's financial statements, the absence of liabilities other than those reflected in its latest balance sheet, the seller's title to the asset-part of the sale and compliance with applicable laws.²⁸⁷² They aim at defining the critical factors in relation to the business, upon which the buyer is prepared to offer the purchase price, and their breach will result in a reduction of the value of the target business and, thereby, a

²⁸⁶⁸ *Ibid.*, at 376

²⁸⁶⁹ Article 10.3.4, Execution version of a Share Purchase Agreement dated 12 June 2006, on file with the author: "None of the limitations contained in this Clause 10.3 (Exclusions and Limitations of the Sellers' Liability) shall apply to any Claim which (i) arises or is increased, or to the extent to which it arises or is increased, as the consequence of, or which is delayed as a result of, fraud, wilful misconduct, wilful concealment or gross negligence by any Seller or (ii) arises from or relates to a breach of Clause 5.3 (Legal Ownership of the Shares)."

²⁸⁷⁰ These are Sub-Clause 8.7 (Delay Damages), Sub-Clause 11.2 (Cost of Remedying Defects), Sub-Clause 15.4 (Payment after Termination), Sub-Clause 16.4 (Payment on Termination), Sub-Clause 17.1 (Indemnities), and Sub-Clause 17.5 (Intellectual and Industrial Property Rights).

²⁸⁷¹ These are Sub-Clause 4.19 (Electricity, Water and Gas), Sub-Clause 4.20 (Employer's Equipment and Free-Issue Materials), Sub-Clause 17.1 (Indemnities) and Sub-Clause 17.5 (Intellectual and Industrial Property Rights).

²⁸⁷² Ehle, B. D., *Arbitration as a Disputes Resolution Mechanism in Mergers and Acquisitions*, *Comparative Law Yearbook of International Business*, (2005), at 294

reduction of the purchase price. The agreement will state a provisional price, which will then be adjusted after closing pursuant to adjustment criteria provided for in the contract.²⁸⁷³

In this context, each warranty states a positive guarantee, e.g. all the taxes have been paid. Possible exceptions, e.g. there is a problem with the taxes of a certain period, are disclosed by the seller to the buyer in the contract or in a separate contractual document, called “disclosure letter”.²⁸⁷⁴ Thus, the parties agree that those exceptions to the warranties, which are expressly stated in the contract or in the disclosure letter, will limit the seller’s liability for the breach of warranties. The buyer may rely on the warranty for the purpose of obtaining compensation to the extent that the relevant events are not expressly set out in the contract or the disclosure letter as exceptions to the warranties. The seller bears the risk for not having disclosed within the contractual documents certain facts, as a consequence of which the buyer will be entitled to seek damages for breach of warranty, even if the buyer was aware of relevant facts that imply a breach of warranty. For example, Article 8.3 of the ICC Model Mergers & Acquisitions Contract provides that the right to damages for breach of any warranties in the agreement will not be affected by any investigation conducted or any knowledge acquired with respect to the accuracy or inaccuracy of or compliance with any such warranty. Article 9.1 declares that the seller shall be liable to the buyer for any liability, loss, damage, cost expense, which the buyer or the target company may incur as a result of any warranty breach. Article 9.2 provides that the liability of the seller in accordance with Article 9.1 shall be treated as any one of the following, as the buyer shall choose and direct: a reduction of the purchase price, or a payment to the buyer, a payment to the target company, or a direct payment to the creditors of the target company. However, the seller will often wish to qualify some representations and warranties, particularly with respect to matters that are beyond its control. The liability of the seller for the relevant risk may be limited by those contractual clauses, under which certain representation and warranties are preceded by the words “as far as the seller is aware” or “to the best knowledge of the seller”. These clauses imply that the parties are not fully aware of the facts covered by the representation or warranty and that the parties share the resulting risk, which has most likely had an effect on the purchase price.

It is argued that the international contracting practices governing the amount of recoverable damages for non-performance are evolved in an attempt to reach a synthesis of the civil law and common law traditions, at the same time offering to the parties to international contracts a discipline as uniform and as certain as possible in spite of the different approaches of the various national laws.²⁸⁷⁵ Essentially, those different approaches lead the contracting parties to devise contractual mechanisms, which aim at restricting the scope of judicial discretion by providing, as much as possible, clarity as to their risk allocation, the sequence of contractual obligations and consequences of its disruption, and the limitations of liability for non-performance to the extent that the freedom of contract allows them to do so.

²⁸⁷³ Peter, Wolfgang, *Arbitration of Mergers and Acquisitions: Purchase Price Adjustment Disputes*, *Arbitration International*, 19-4 (2003), at 495

²⁸⁷⁴ ICC Model Mergers & Acquisitions Contract 1 - Share Purchase Agreement, ICC Commission on Commercial Law & Practice, ICC Publication No. 656, 2004 Edition, at 11

²⁸⁷⁵ Draetta, Ugo, *The Notion of Consequential Damages in the International Trade Practice: A Merger of Common Law and Civil Law Concepts*, *International Business Law Journal*, (1991), at 487

2. Arbitral Decision Making

The decision maker, applying *lex mercatoria*, may derive many established rules as to the issue of damages for non-performance in the order of international commerce from the national legal systems and international instruments through the specialized consolidations on the basis of an abstract reasoning. However, it is observed that, although there has been an almost universal consensus among arbitral tribunals that damages for breach of contract should place the aggrieved party in the position that it would have been in had the contract been performed, the assessment of the amount of recoverable loss and the resulting awards of damages by arbitral tribunals deciding international contract disputes have varied greatly.²⁸⁷⁶ This variety results from the fact that almost all national legal systems allow the *ex post* decision maker to resort to equity *infra legem*, where the exact calculation of the amount of damages is not possible. The International Court of Justice made this point in judgment in the North Sea Continental Shelf case in 1969: “in short it is not a question of applying equity simply as a matter of abstract justice, but of applying a rule of law which itself requires the application of equitable principles.”²⁸⁷⁷ This is particularly relevant to the resolution of state party disputes, where the tribunals have to determine the value lost, as a result of expropriation or breach by the state party, on the basis of projected future earnings that may be greatly affected by ever-changing and often unpredictable economic circumstances.

In order to overcome the criticisms of splitting the difference in terms of compromise awards and the unpredictability of outcomes in the arbitral proceedings, the decision maker applying *lex mercatoria* should reflect clearly as possible, in the award, the abstract reasoning as to the determination of the amount of recoverable damages, by resorting to limitations both articulated by the parties in the contract or their choice of default rules, and found by the decision maker in the form of the established rules in the particular case. In the particular cases, the arbitrators rightfully feel themselves more concerned with the outcome than a formalistic reference to a specific legal provision. However, this flexibility should not relieve the arbitrators from their duty to give reasoned awards, which should be considered as one of the procedural principles of *lex mercatoria*. The respect for articulated rules, the search for established rules, and the reasoned decision making, as required by *lex mercatoria*, may result in more principled decisions, which accurately give effect to the reasonable expectations of the parties to a particular dispute, as opposed to the criticism of uncertainty associated with the institution of arbitration in relation to the determination of the amount of damages.

a. Principle of Full Compensation

Under national legal systems and international instruments, the damages for non-performance are granted for the compensation of the loss incurred by the aggrieved party. Thus, in assessing the loss suffered by the aggrieved party, the first established rule in the order of international commerce to be considered by the decision maker applying *lex mercatoria* is the principle of full compensation, which includes loss suffered (*damnum emergens*), and the profit lost (*lucrum cessans*). It is argued that, the arbitral tribunals recognize the rule of full compensation as a general principle of law, and consider the aggrieved party entitled to recover both losses incurred as well as gains of which it was deprived because of the non-

²⁸⁷⁶ Gotanda, John Y., *Damages in private international law*, *Receuil des Cours*, 326 (2007), at 84

²⁸⁷⁷ North Sea Continental Shelf Cases (Federal Republic of Germany v. Denmark; Federal Republic of Germany v. Netherlands), Judgment of 20 February 1969, I.C.J. Reports, (1969), p.3, at 47

performance.²⁸⁷⁸ In the ICSID Amco I Award, the tribunal stated that “the full compensation of prejudice, by awarding to the injured party the *damnum emergens* and the *lucrum cessans* is a principle common to the main systems of municipal law, and therefore, a general principle of law which may be considered as a source of international law.”²⁸⁷⁹ In the Sapphire Award, the arbitrator explained the principle of full compensation as follows: “According to the generally held view, the object of damages is to place the party to whom they are awarded in the same pecuniary position that they would have been in if the contract had been performed in the manner provided for by the parties at the time of its conclusion. . . . This rule is simply a direct deduction from the principle of *pacta sunt servanda*, since its only effect is to substitute a pecuniary obligation for the obligation which was promised but not performed. It is therefore natural that the creditor should thereby be given full compensation. This compensation includes loss suffered (*damnum emergens*), for example expenses incurred in performing the contract, and the profit lost (*lucrum cessans*), for example the net profit which the contract would have produced.”²⁸⁸⁰

In ICC Case No 10578, the arbitral tribunal referred to general principle of full compensation to guide its decision rather than specific legal texts cited by the claimant. The dispute arose from a distributorship agreement governed by Swedish law, pursuant to which the claimant, an Italian company, acquired exclusive rights to market in Italy products manufactured and supplied by the Swedish defendant. The claimant initiated arbitration proceedings, alleging the termination of the agreement by the defendant to be invalid and claiming damages for the violation of its rights. The arbitral tribunal, held that the claimant was entitled to be compensated for all damages, including loss of profits it suffered due to defendant’s breach of the agreement, in accordance with general principles of Swedish law on compensation of damages for breach of contract, which provide that the victim of a breach of contract may claim to be put, in terms of financial compensation, in the same situation it would have been in if the breach had not occurred. The tribunal stated that “The legal texts cited by [the claimant] do merely reflect in specific areas this wider principle under Swedish law. Given that the relation between the parties is neither one of simple sales contracts nor of a commission agency, but an exclusive distributorship, such general principle of Swedish law on compensations will guide the Arbitral Tribunal in its decision on the quantum of [the claimant]’s claims.”²⁸⁸¹

In awarding damages in accordance with the established rule of full compensation, the decision maker applying *lex mercatoria* may use two different bases of assessment, namely cost of cure or difference in value, which are recognized by many legal systems and applied according to which one is more appropriate in the particular circumstances of the case. The difference in value can be based, if available, on the cost of an actual or hypothetical substitute performance, with respect to which many legal systems draw a distinction between the “concrete” and “abstract” method of quantifying that cost, but neither method necessarily forms the limit of recovery, which may include incidental and consequential loss. Particularly,

²⁸⁷⁸ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 832

²⁸⁷⁹ ICSID Award Amco Asia Corp. et al. v. Republic of Indonesia, International Legal Materials, 24 (1985), at 1036-1037

²⁸⁸⁰ Sapphire International Petroleum Ltd. v. National Iranian Oil Co., ad hoc award of 15 March 1963, International Legal Report, 35 (1967), at 185-186

²⁸⁸¹ ICC Final Award in Case 10578, April 2001, ICC International Court of Arbitration Bulletin, Special Supplement 2005: UNIDROIT Principles: New Developments and Applications, (2005), at 85

it is generally recognized that contract may give rise to two quite separate expectations: that of receiving the promised performance and that of putting into some particular use.²⁸⁸²

In the application of the principle of full compensation, the sole arbitrator in ICC Case No 5294 used the cost of cure as the basis of assessment of loss. In this assessment, the arbitrator considered the cost of both an actual and hypothetical substitute performance in order to determine the appropriateness of the costs of actual cure. The case concerned a construction contract whereby a Danish firm subcontracted an Egyptian firm with regard to the erection of certain buildings in Egypt for an Egyptian employer. The agreement was governed by Swiss law. Due to disputes about delays in the execution of the works, the Danish firm took over the further execution of the works, as provided for in an amendment agreement, and finished the unexecuted part of the works itself. The Danish firm initiated the arbitral proceedings claiming compensation for the part of the works, which it had executed itself. The arbitrator noted that the documents submitted did not contain indications that would prove the delays were attributable to reasons beyond the defendant's control. The tribunal stated that the case can and must be decided under Article 7 of the amendment agreement, which provided a specific procedure for the method of compensation for delays in the works, without further inquiries into Swiss law.²⁸⁸³

The arbitrator found that the claimant was entitled to invoke Article 7 and acted correctly under that provision in rejecting the defendant's further services and continuing by a third party or itself a construction work which ought to have been done by the defendant. Thus, the arbitrator considered that claimant was entitled to recover the cost expended in good faith for such completion of the works, less the amounts received for such work from the employer. However, the arbitrator noted that the cost expended by the claimant to complete the works substantially exceeded the total sum contractually allotted to the performance of all the civil works. In order to check the appropriateness of the expenses incurred, the arbitrator appointed an expert to produce an estimate of what the cost of completing the works would have been if done by an Egyptian civil contractor and, alternatively, if done by an international civil contractor. In view of the higher costs incurred by an international contractor in the expert's report, the arbitrator questioned whether the defendant must absorb the additional expense caused by the claimant assuming the work itself rather than using another Egyptian contractor. The arbitrator was satisfied that claimant's action was, under the circumstances, a reasonable if not only solution. Given that there already had been considerable delays in

²⁸⁸² Treitel, G.H., Remedies for Breach of Contract (Courses of Action Open to a Party Aggrieved), International Encyclopedia of Comparative Law, Vol. 7 Ch. 16, Tubingen: Mohr, 1976, at 28-29; However, such additional damages will be subject to the established or contractual limitations to the amount of damages. In ICC Case No 4237, which concerned a sales contract between a Syrian buyer and a Ghanaian seller, the sole arbitrator applying English law stated that "The generally accepted rule in world trade is that the measure of damages in the case of non-delivery of goods is the difference between the contract price and market price of the goods at the time when they ought to have been delivered, where there is an available market for the goods in question. This rule is also law in both English (Ghanaian) and Syrian law." In the case, the buyer claimed damages for a lost profit over the value of the goods which were not delivered. However, the arbitrator rejected this claim. The arbitrator stated that "In certain cases, a buyer is entitled to special damages suffered by him as a result of non-performance of the seller, in addition to the price difference. However, such damages must reasonably have been foreseen by the seller... It is inherent to merchants that they make profits or losses on resale. It is not inherent to merchants that they always make a profit. The alleged 10% charge is an artificial 'profit' which does not reflect truly the mechanism of determining a price by supply and demand on the market. The charge therefore could not reasonably have been foreseen by Defendants." ICC Award in Case No. 4237, Yearbook Commercial Arbitration, (1985), at 58-59

²⁸⁸³ ICC Final Award in Case No. 5294, February 22, 1988, Yearbook Commercial Arbitration, (1989), at 144

execution of the project, which was undertaken as a whole under a tight time schedule vis-à-vis the employer, the arbitrator deemed reasonable to assume that the involvement of another Egyptian contractor would have involved more time for getting started the job and the risk of not meeting the employer's deadlines, and would have complicated the scheduling and installation of the works. Thus, the arbitrator held that claimant was acting diligently and in good faith in carrying out the work itself in lieu of the defendant, and was, therefore, entitled to full recovery of its expenses.²⁸⁸⁴

Unless required by the default rules chosen by the parties or determined as governing the contract by means of the application of *lex mercatoria* at the stage of conflict of laws, the decision maker applying *lex mercatoria* does not have to discuss the distinction made by the national legal systems between expectation (positive) interest and reliance (negative) interest, according to which the latter interest is generally awarded when it is not possible to establish lost profits with a reasonable degree of certainty. The decision maker may instead adopt the simpler solution that can be derived from the international instruments, under which the loss consists of the accrued losses (*damnum emergens*), and the lost profits (*lucrum cessans*), while taking into account any gain resulting to the aggrieved party from the non-performance, and damages can be rejected whenever the existence of loss cannot be established with reasonable certainty.

In ICC Case No. 10422, the arbitral tribunal took into account the avoided costs by the aggrieved party as a result of the non-performance of the other party. The case concerned an unlawful termination of an exclusive distribution agreement by the principal. The tribunal decided to apply “general principles and rules of international contracts, i.e. the so-called *lex mercatoria*”, and to refer in this context to the UNIDROIT Principles. Considering that the principal unjustifiably terminated the agreement, the tribunal held that the principal was obliged to compensate the harm caused to the distributor by the termination. The distributor requested damages for lost profits. The distributor, considering the total amount of sales based on wholesale prices in a certain period of performance before the termination of the agreement, argued that it would be reasonable to expect at least similar results in the relevant period after termination. The arbitral tribunal noted that the claimant applied a gross margin with respect to the volume of business based on the wholesale price. The tribunal held that lost profits should be calculated, not on the basis of the gross margin of the forecast sales volumes, but on the basis of the net margin, i.e. the net gain after all expenses have been deducted, which is the difference between the gross margin and the avoided costs or harm and, and in this respect, referred to Article 7.4.2 of the UNIDROIT Principles. The tribunal stated that this principle has on numerous occasions been recognized in arbitral awards. In the absence of any indication concerning the calculation of net margin, the tribunal held that it had to use the criterion contained in Article 7.4.3 (3) of the UNIDROIT Principles, according to which where the amount of damages cannot be established with a sufficient degree of certainty, the assessment is at the discretion of the court.²⁸⁸⁵

In ICC Case No. 8362, the claimant distributor concluded an exclusive distributorship agreement with the defendant manufacturer for the distributorship in Europe of a product manufactured by the defendant. The agreement was governed by the law of New York. The

²⁸⁸⁴ Ibid., at 144-145

²⁸⁸⁵ ICC Award in Case No. 10422, 2001, Excerpts of the original French version of the award have been published in *Journal du droit international*, (2003), pp. 1142-1150 Available in English at <http://www.unilex.info/case.cfm?pid=2&do=case&id=957&step=FullText>

claimant claimed damages arising from the unlawful termination by the defendant of the agreement. The claimant calculated its expectation interest as equal to the estimated gross profits that it would have received over the duration of the distributor agreement, but later amended its claim and calculated its expectation interest as equal to its lost net profits, namely estimated lost gross profits less variable costs that would have been incurred in connection with its performance under the distributor agreement. The parties agreed that under New York law the proper measure of recoverable damages is lost net profits, but disagreed as to the meaning of “net profits”.²⁸⁸⁶

The sole arbitrator stated that “Under New York law, the proper measure of expectation damages is net losses as measured essentially, in a case such as this, by lost net profits. The case authorities cited by the parties, however, do not provide a specific general rule for calculating net profits to be consistently applied in all cases, in particular as regards the question of deduction of operating expenses. In ascertaining the essential principle of New York law, it is necessary to look at the facts of the cases cited and the purpose underlying the decisions, which is to grant a party no more nor less than its reasonable expectation interest.” The arbitrator considered that the essential principle was that a party must deduct from gross profits the costs associated with the performance that have been avoided, but there was not any rule of general application that expectation damages are equal to the net accounting profit (or loss) of the business entity as a whole, or any general rule that only variable costs, in an accounting sense, are deducted from gross revenues in determining lost profit. The arbitrator stated that “The intent of the court is that the aggrieved party be placed in the same economic position that it would otherwise have enjoyed, but for the breach. This requires no more than that the benefit of avoiding performance – the cost avoided – be deducted from the value to be received through performance. This is fundamentally what the courts mean by 'lost net profits', regardless of what specific deductions the courts have required, or not required, in given cases.”²⁸⁸⁷ Thus, the arbitrator decided to deduct from gross revenues only the cost avoided by the claimant.

While there is relatively little difficulty as to the basis of assessment of the accrued loss (*damnum emergens*), which is in principle the expense incurred by the aggrieved party, although some of this may be too remote, lost profits (*lucrum cessans*) can be calculated in various ways depending on the circumstances of the case, but none of them will provide a mathematical precision and the estimate of the decision maker will be highly influential on the outcome. In the case of an ongoing contractual relationship, the measure of damages for lost profits arising from the termination of contract will usually be based on the past performance of the party in breach. This measure will be awarded for the period up to the time when the contractual recognition of entitlement ends, which depends on the circumstances of a particular case, such as up to the time a valid basis for contractual termination exists. Thus, lost profits will be awarded until ordinary expiry of the contract or until such time when the contract could have been terminated ordinarily or under its own provisions.

ICC Case No 5418 concerned an agreement under which, the Hungarian exporter granted the English importer the sole and exclusive rights for the import and sale in the territory of the United Kingdom of certain Hungarian wines for a period of ten years between 1977 and 1987. The English exporter claimed for damages consisting mainly of loss of profits, which resulted

²⁸⁸⁶ ICC Award in Case No. 8362, 1995, *Yearbook Commercial Arbitration*, 22 (1997), at 175

²⁸⁸⁷ *Ibid.*, at 175-176

from the wrongful termination of the agreement by the Hungarian exporter in 1985. The agreement designated Hungarian law as the applicable law.²⁸⁸⁸ The arbitral tribunal stated that the compensation of damages under Hungarian law includes loss of profit. According to the tribunal, when estimating the damages the tribunal has to try to arrive at an amount of damage which is plausible under the given circumstances, which has to be proven by the claimant, who has the burden of proof for damages. The tribunal stated that “The estimation of a loss of profit is mainly based on expectations of the future. In this context the tribunal has to start by taking into account the history of developments in the past. It was, therefore, an appropriate method of the claimant to present the calculation of their profit during the years 1980 through 1984 and for the first three months of 1985”.²⁸⁸⁹ According to the tribunal, a claimant who seeks to recover damages for loss of profit upon wrongful termination of a long-term sales contract and who seeks to persuade a tribunal that the lost of profit would be more substantial than had been earned in the period immediately preceding termination of the contract has to adduce strong and compelling evidence that marketing circumstances would have significantly improved had the contract continued. The tribunal considered that since forward predictions are necessarily to some extent speculative, the tribunal, which is asked to award damages for loss of increased future sales, should require a high standard of proof that such increases were probable. The tribunal required such evidence that established a substantial and sustained increase in actual demand for the relevant wines after 1984. However, the evidence adduced by the claimants in the case fell well short of convincing the tribunal that such an increase would probably have occurred. Thus, the tribunal concluded that the sales volumes for 1985, 1986 and 1987 would probably be about the same overall as the average of the three previous years, and awarded the net profit which the claimant would have derived from the agreement, had the agreement been performed until the end of its term in 1987.²⁸⁹⁰

In ICC Case No. 5946 regarding an exclusive agency agreement for two varieties of controlled wines bottled and supplied by the claimant, the arbitrator, having found that the claimant’s termination and subsequent refusals to sell were unlawful, held the claimant liable to the extent that respondent was able to show that it suffered damages proximately caused to the respondent by such improper behavior of claimant. Applying New York Law, the arbitrator stated that “An aggrieved party may recover all damages suffered from a breach of contract, including losses sustained as well as gains prevented The object is to put a party in the posture he would have enjoyed had the contract not been breached While the burden of proof rests upon Plaintiff in a case of this kind, damages need not be established with absolute certainty.... In the context of a breached exclusive dealership in which a manufacturer terminates the services of an exclusive distributor, sales consummated and business performed by the distributor in the exclusive territory before the breach or by the manufacturer after the breach often form the basis for a reasonable accurate estimate of the profits the distributor might have realized had the relationship not been terminated.”²⁸⁹¹ The arbitrator considered that the defendant had almost entirely concentrated on the first variety of wine, and its performance regarding the second variety of wine was very poor. The arbitrator stated that even if the agreement had not been terminated by the claimant, it could not have been expected that the defendant would have attained a substantial volume regarding the second variety of wine. Accordingly, the arbitrator held that the defendant failed to show any

²⁸⁸⁸ ICC Award in Case No. 5418, 1987, Yearbook Commercial Arbitration, (1988), at 91

²⁸⁸⁹ Ibid., at 99

²⁸⁹⁰ Ibid., at 100

²⁸⁹¹ ICC (Final) Award in Case No. 5946, 1990, Yearbook Commercial Arbitration, (1991), at 110-111

loss of business regarding the second variety of wine on account of the termination of the agreement, and thus, it was not entitled to damages regarding the second variety of wine. With regard to the first variety of wine, the arbitrator took into account a drop in sales volume in the period preceding termination, and, assuming this diminution of turnover would have continued through the remaining term of the agreement, the arbitrator calculated the lost hypothetical profits accordingly.²⁸⁹²

In such a calculation of damages, the obligations of best efforts may have a limiting effect on the amount of damages recoverable by the aggrieved party. In distributorship agreements, the principal's lost profits will commonly be measured by the past sale performance of the agent. If the agent only undertook a best effort obligation in this regard, which places the burden of proving whether the obligor has satisfied the requirements of its obligation onto the obligee, the principal will have to prove that the agent did not exert its best efforts in its sales performance and could have achieved better, in order to increase the basis of calculation for its lost profits. Where the principal fails to satisfy its burden of proof, the amount of damages for lost profits of the principal will be limited to a sum determined on the basis of the actual sale performance of the agent in the past period.

In ICC Case No. 7006, the supplier initiated arbitral proceedings against the distributor, by claiming recovery of damages caused by the illegal termination of the distribution agreement by the distributor. The agreement was governed by French law. In calculating the recoverable damages, the arbitrator first defined the obligations of the distributor under contract as obligations to use best efforts, due to the absence of any contractually stipulated purchase or sales quota to attain. According to the arbitrator, the scope of obligation of best efforts would preclude unilaterally terminating the contract, even when allegedly motivated by solicitude that the supplier might more profitably distribute its products through other channels.²⁸⁹³ In the arbitrator's view, the distributor must develop and maintain the market for the product in the assigned territory to the best of its ability with the means at its disposal. The arbitrator stated that "all that can be expected of the distributor is that it do its best with the resources – financial, material and human – present when the contract was entered into, or reasonably within its reach."²⁸⁹⁴ Thus, the arbitrator considered that the loss of profits which the supplier may claim should be confined to those lost sales to the distributor which would probably have been made in order to replace inventory which, in the absence of any other guide, would presumably have continued to be sold by the distributor at the sale volume it attained before its performance of the contract ceased. In the absence of any contractually stipulated quota, or proof by the supplier that the distributor's failure to attain higher levels of sales was due to its breach of an obligation of best efforts, the arbitrator concluded that until the distributor abandoned all further market activity, it in fact complied with such an obligation, and that sales it did achieve should form the measure of claimant's loss after the abandonment.²⁸⁹⁵ Thus, the best efforts obligation indirectly limited the amount of recoverable damages due to the supplier by making the allegedly poor sale performance of the distributor as the basis for the measure of damages for lost profits, in the absence of proof by the supplier that the distributor failed to use its best efforts.

²⁸⁹² Ibid., at 111-112

²⁸⁹³ ICC (Final) Award in Case No. 7006, 1992, Yearbook Commercial Arbitration, (1993), at 61

²⁸⁹⁴ Ibid., at 62

²⁸⁹⁵ Ibid.

b. Established Limitations to the Amount of Damages

The principle of full compensation requires the decision maker to give effect to the expectation of the aggrieved party from the performance of the contract by putting it into as good a financial position as that in which it would have been if the contract had been duly performed. The reasonableness of this expectation is assured by various limitations to the sum recoverable by the aggrieved party as damages, under other established rules. All national legal systems agree in placing such limitations on the recoverability of damages for non-performance.²⁸⁹⁶ The decision maker will apply those established rules, the knowledge of which is considered as part of the contracting parties' cost of enabling the correspondence of the expectations in the order, in making the allocational ex post decision with regard to the residual contractual rights and obligations and risk allocations. Thus, the aim of fully compensating the aggrieved party's loss must often give way to the aggrieved party's costs of enabling correspondence of expectations, which lay down certain limits beyond which the non-performing party will not be held liable in damages. Due to the underlying standard of reasonableness in these limitations, these rules regarding the assessment of damages leave much to the decision maker's discretion. The need to deal with such a situation that cannot always be foreseen in advance is reflected in the flexibility of the default rules relating to damages for non-performance.²⁸⁹⁷ In view of these considerations, the decision maker applying *lex mercatoria* should be as explicit as possible in its award in relation to the consideration of the established limitations to the amount of damages.

1. Causation

The aggrieved party may only recover its loss that was directly caused by the non-performance of the other party. This simple and logical rule apparently determines the amount of recoverable damages as a matter of fact. However, in practice, particularly in the transactions governed through legal uncertainty, the task of determining the causes of the loss claimed by the aggrieved party due to the non-performance may be much more difficult than the *prima facie* simplicity of the rule would suggest. By the application of this limitation, the decision maker applying *lex mercatoria* should determine through a contextual approach whether the loss allegedly incurred by the aggrieved party was caused directly by the non-performance of the other party. Where the decision maker establishes that there are multiple causes of the alleged loss, only the loss directly caused by the non-performance may be included in the amount of damages. If the share of non-performance in the alleged loss cannot be determined with mathematical precision, the concern for accuracy under *lex mercatoria* requires a discretionary assessment of the respective weight of all causes and, if necessary, a subsequent reduction in the amount of the alleged loss, rather than all-or-nothing solutions. Such a contextual approach and discretionary assessment may precede, as a matter of interpretation of contract and its supplementation with individualized terms, the approach of national legal systems, which mainly apply the principle of causation as a means for either establishing liability for non-performance or excusing the party from the liability for non-performance.

In ICC Case No. 5948, the arbitral tribunal applied the requirement of causality to reduce the alleged loss of the contractor arising from the employer's delay in making advance payment,

²⁸⁹⁶ Treitel, G.H., *Remedies for Breach of Contract: A Comparative Account*, Clarendon Press, 1988, at 143

²⁸⁹⁷ Friedmann, Daniel, *Rights and Remedies*, in Nili Cohen & Ewan McKendrick (eds.), *Comparative Remedies for Breach of Contract*, Oxford: Hart, 2005, at 17

on the basis of its discretion and customs in the construction industry. In the case, an advance payment had been duly certified by the engineer and the contractor had promptly provided the employer with an advance payment guarantee. However, the advance payment was paid with a delay of 202 days and, consequently, the contractor claimed damages for late payment of the amount involved. The tribunal noted that, “in principle, and consistently with the law of obligations of the Employer's State”, the contractor should be able to recover any net extra expenditures and liabilities incurred by it which (i) were caused by the breach, (i.e. which were rendered abortive by the lateness of the advance payment or would not have been incurred at all but for that lateness), and (ii) were a reasonably foreseeable consequence of that breach.²⁸⁹⁸ With respect to the issue of foreseeability, the tribunal considered that it was from the outset reasonably foreseeable, and in fact, foreseen by the employer that any failure to make payments was quite likely to result in delay to the work. However, the tribunal stated that “the burden is on the [contractor] to establish with reasonable particularity the nature and extent of the losses it claims to have suffered” and the tribunal cannot simply assume that the contractor was unable to do any productive work at all during the 202 days or that a 202 day delay in effecting the advance payment caused as much loss to the contractor as if every subsequent contractual payment had also been deferred by 202 days. The tribunal added that “on any view the amount recoverable as damages would not include the value of work performed which earned remuneration under the Contract.”²⁸⁹⁹

In determining what costs “caused by the breach of contract” and “rendered abortive by the lateness of the advance payment”, the tribunal first assessed the total costs incurred over the period of 202 days, and then deducted from that amount its assessment of costs allocable to productive work performed in that period. Since no evidence was presented by either party in respect of any calculation for the value of productive work, the tribunal referred to the custom in the industry. According to the custom, upon the award of a contract, the main activities of a contractor concern preparatory work, which includes mobilization and logistics for the entire project whereby special emphasis lies on the site installation, the recruitment of personnel, the purchasing of plant, equipment and materials and their transport to the site. The costs of those preparatory works, which can be used when the project starts at a later date, become abortive to the extent that the personnel in charge of the project is no longer in a position to achieve productive work, but cannot be dismissed or directed to other projects in view of the expectation that the works may actually continue at any time. According to the tribunal, the period of the advance payment delay in the case was ultimately of such length that most of the personnel and other time-related costs became abortive. In view of these considerations, the tribunal found that “a percentage of 20% of the allowable costs for home office overheads, staff salaries, medical insurance, staff expenses, postage and DHL, air fares, sundry expenses, hotel accounts, visa fees, site electricity and telephone/telex was not abortive and 20% thereof should be deducted as the value of productive work.”²⁹⁰⁰

Thus, the tribunal applied the requirement of causality in the event of the employer's late payment to determine the extent of loss suffered by the contractor, on the basis of a contextual approach, by focusing on the customs in the relevant industry, which indicated that the contractor had the ability to do some productive work during the period of delay. The tribunal, referring to those customs, made a distinction between, on the one hand, the contractor's costs

²⁸⁹⁸ ICC Award in Case No. 5948, 1991, ICC International Court of Arbitration Bulletin, 9-1(1998), at 81

²⁸⁹⁹ *Ibid.*, at 82

²⁹⁰⁰ *Ibid.*, at 82

that were rendered abortive by the employer's breach of contract, on the other hand, the contractor's costs that could be put in furtherance of its performance of the work, despite the employer's breach of contract. The share of the latter costs in the amount of alleged loss incurred by the contractor during the period of delay was apparently determined on the basis of a discretionary power. Then, those costs were deducted from the alleged loss, since they were considered as being required and still useful to achieve the completion of the works and, thus, covered by the remuneration under the contract. In this sense, those costs did not cause any loss to the contractor.

2. Foreseeability

In the order of international commerce, it is an established rule that the non-performing party is only be liable for such damages as he could have foreseen at the time of the conclusion of the contract. The basic premise of this limitation is that the parties can reasonably be expected to have entered into the agreement on the basis of foreseeable risks. It rests on the claim that, had the breaching party actually known of the extent of losses his breach might cause, he would not have contracted at all or would have contracted on different terms.²⁹⁰¹ Under the economic analysis of law, it is argued that this limitation implies that, where a risk of loss is known to only one party to the contract, the other party is not liable for the loss if it occurs and, thus, the party with knowledge of the risk is induced either to take any appropriate precautions himself or, if he believes that the other party might be the more efficient loss avoider, to disclose the risk to that party and pay him to assume it.²⁹⁰² In accordance with these considerations, the application of this limitation is an issue of risk allocation under *lex mercatoria* and will be based on the specific allocation of risks as agreed between the parties, and the residual allocation of risks as determined through the contextual approach of the decision maker in ascribing a certain degree of knowledge to the parties respectively. The decision maker will attribute to the reasonable person the knowledge of surrounding circumstances which such a person could normally be expected to have, and also such additional knowledge as the party in breach in fact had.

It is argued that the principle of foreseeability has an international scope and the reasoning of the arbitrators is consonant with both the English case of *Hadley v. Baxendale* and Article 1150 of the French Civil Code.²⁹⁰³ Some awards have held, by way of a general principle, that only direct and foreseeable losses are capable of giving rise to compensation. Those awards commonly implied a close link between the foreseeability and causation, particularly through the concept of remoteness. This was also apparent in ICC Case No 5948, which was examined above in relation to the causation. In the ICSID *Amco I Award*, the tribunal stated that "according to principles and rules common to the main national legal systems and to

²⁹⁰¹Gordley, James, *The Foreseeability Limitation on Liability in Contract*, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, C.E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 215-216, 223-224: (Gordley argues that there is no good reason why foreseeability, in itself should matter. In his view, lack of foreseeability matters because it leads to disproportionality between the amount of damages the aggrieved party claims and the price he was charged, and allowing such damages to be recovered is unfair on the basis of Aristotle's concept of commutative justice. In his view, a contract is fair when it is balanced in the sense that each part is compensated for the risks it bears and, thus, unfair if the damages for which a party may be liable are unforeseeable, because the party who bears the risk of breaching a contract and paying damages is not compensated for doing so.)

²⁹⁰²Posner, Richard A., *Economic Analysis of Law*, Little, Brown, 2nd ed., 1977, at 94

²⁹⁰³Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 647

international law, the damages to be awarded must cover only the direct and foreseeable prejudice. The requirement of directness is but a consequence of the requirement of a causal link between the failure and the prejudice; and the requirement of foreseeability is met practically everywhere.”²⁹⁰⁴ Similarly, in an ad hoc award, the tribunal stated that “There is ... a common legal principle [prevailing in the Arab countries]...., namely the compensatory principle: a party may claim the *damnum emergens* (*ma lahaqahu min darar*) and the *lucrum cessans* (*ma fatahu min ribh*) suffered by it as a direct result of a breach of contract, provided (in the absence of wilful default (*ghish*) or grave fault (*khata' gasim*)) such result was reasonably foreseeable by the parties when they entered into the contract.”²⁹⁰⁵ Thus, it is observed that in arbitral practice, causation often becomes blurred with the notion of foreseeability since, under the foreseeability test, the claimant is first to establish causation by showing that the breach and the damages are linked, the latter being the necessary consequence of the former or a direct and immediate result.²⁹⁰⁶

In ICC Case No 10346, the defendant’s non-performance of its obligations to collaborate resulted in the failure to register their contract for the sale of electricity in the public registry, which was the condition for the final efficacy of the contract.²⁹⁰⁷ The contract contained a choice of law clause in favor of Colombian law. The arbitral tribunal held that the defendant’s failure to collaborate with the claimant in order to adjust the provisions of the contract to the requirements of the public authority thereby obtaining the registration of the contract blocked all possibility of the performance of the contract and gave rise to the obligation to make full compensation. The tribunal, referring to the relevant articles of the Colombian Civil Code, stated that “the question of compensation would appear to be resolved merely by applying the concepts of *damnum emergens* and *lucrum cessans*, the first of which means a reduction in net worth (an outlay) and the second a frustrated gain (income not received)”.²⁹⁰⁸ The tribunal further noted that in Colombian law, “for a loss to be compensated it must be “certain” rather than a “contingent” loss.” The tribunal considered that the classification of damage as certain or as contingent, arising out of situations which were prevented from occurring, constitutes a necessary filter for the determination of the reasonable losses. The tribunal stated that “Having set out the aforementioned framework as the reference to evaluate the absence or presence of recoverable losses, the Tribunal also comes up against clause 14.3 of the Contract, the text of which clearly has its origins in the Anglo-Saxon legal systems and makes it necessary to venture into the area of “direct” and “indirect” loss in order precisely to understand the provision, which is consonant with the principle that the reparation for the loss, whilst it has to compensate the aggrieved party, which is a mandatory parameter in the evaluation, cannot impose exaggerated burdens on the liable party.”²⁹⁰⁹

²⁹⁰⁴ ICSID Award *Amco Asia Corp. et al. v. Republic of Indonesia*, International Legal Materials, 24 (1985), at 1036-1037

²⁹⁰⁵ Ad Hoc UNCITRAL Award of 17 November 1994, *Banque Arabe et Internationale d’Investissements et al v Inter-Arab Investment Guarantee Corporation*, Yearbook Commercial Arbitration, 21 (1996), at 37

²⁹⁰⁶ Gélinas, Paul-A., General Characteristics of Recoverable Damages in International Arbitration, in Yves Derains & Richard H. Kreindler, (eds.), *Evaluation of Damages in International Arbitration*, ICC Publication No. 668, 2006, at 14

²⁹⁰⁷ ICC Award in Case No. 10346, December 2000 (*Barranquilla Colombia*), ICC International Court of Arbitration Bulletin, 12-2 (2001), at 106

²⁹⁰⁸ *Ibid.*, at 113

²⁹⁰⁹ *Ibid.*, at 114

According to the tribunal, “It is not however enough to denote a loss as direct, as regard must also be had to the distinction between “foreseeable” and “unforeseeable” losses, with compensation being payable in relation to the former but not in relation to the latter, save where the debtor had acted fraudulently.” In this regard, the tribunal referred to the English decision in *Hadley v. Baxendale* and Article 7.4.4 of the UNIDROIT Principles, for characterizing the loss to the criterion of what is in the contemplation of the parties, considering that Colombian law has a limited development in case law on the rule of foreseeability of loss.²⁹¹⁰ Accordingly, on the question of the connotations of having a strict causal relationship and the need for the loss of profit (*lucrum cessans*) claimed by the claimant to have been foreseeable, the tribunal considered it sufficient to mention, in relation to the first point, that the only reason proved in these proceedings for the frustration of the claimant's expectations was the inexcusable non-performance of the defendant and, in terms of the second point, the requirement of “foreseeability” was clearly met since, whatever method of analysis was used, the loss of profit corresponds, as Article 7.4.4 of the UNIDROIT Principles states, to “what [defendant] could have reasonably have contemplated at the time of entering into the contract as the probable consequence of its breach”, or to what was “in the contemplation of both parties”, as stated in *Hadley v. Baxendale*. According to the tribunal, it was quite clear that the essential objective of the claimant in taking part in the public tender and, naturally, in entering into the contract with the defendant, was to obtain a return on its investment. Thus, the tribunal ordered the defendant to pay damages, corresponding to the claimant's loss of profit.²⁹¹¹

Particularly, the decision maker applying *lex mercatoria* should consider that the element of lost profits under the established rule of full compensation is in principle foreseeable for the party in breach in the context of international commercial contracts. Accordingly, it is argued in the doctrine that the recoverability of lost profits is a general principle, and it is not invalidated by the notions that indirect, consequential or speculative damages are excludable.²⁹¹² In ICC Case No 5418, the long-term supply agreement, underlying the dispute, designated Hungarian law as the applicable law. The defendant, the Hungarian foreign trade company, argued that even if the claimant, the English importer, had suffered losses as a result of the defendant's breach of the agreement, the defendant was not liable for its lost profits, among others, on the basis of a Hungarian rule, which provided that the party who caused the damage shall redress the damage which is direct consequence of his conduct and which he could take into consideration as a possible consequence of breach of contract at the time the contract was made.²⁹¹³ The defendant also requested that the arbitral tribunal should ask for independent information about Hungarian law. The tribunal rejected this request and decided to do its own research and to hear the experts of the parties.²⁹¹⁴ The tribunal considered that the loss of profit for which the claimant claimed compensation in damages was a direct consequence of the breach of agreement by the defendant in failing to make continued deliveries under the long-term supply agreement. The tribunal further stated that this was just the kind of loss which, at the time when the agreement was entered into, was the reasonably foreseeable consequence of refusal to continue supplies to the claimant as

²⁹¹⁰ *Ibid.*, at 106-115

²⁹¹¹ *Ibid.*, at 115

²⁹¹² Paulsson, Jan, the Expectation Model, in Yves Derains & Richard H. Kreindler, (eds.), *Evaluation of Damages in International Arbitration*, ICC Publication No. 668, 2006, at 59

²⁹¹³ ICC Award in Case No. 5418, 1987, *Yearbook Commercial Arbitration*, (1988), at 101

²⁹¹⁴ *Ibid.*, at 102

exclusive British distributor, and which would result from the subsequent marketing of the relevant goods by another British distributor.²⁹¹⁵

It is argued that the intentional breach should be recognized as an exception to the foreseeability limitation since, while the foreseeability limitation requires that the defendant should not have to bear, without compensation, the risks of breaching a contract and paying damages, there is no reason he should be charging extra in compensation for the risk of its intentional breach, which he could eliminate by simply deciding to abide by its contract. In this view, if the defendant intentionally breaches the contract, there is no injustice in holding him liable for deliberately destroying the claimant's property, even though the contract price did not compensate him for bearing the risk of doing so.²⁹¹⁶ However, under *lex mercatoria*, the element of the absence of intentional breach in the requirement of foreseeability should be relevant only to those cases, where the terms of the contract or the applicable default rules require so. In other cases, the extent of recoverable damages should not be determined on the basis of the character of the non-performance, such as negligent or intentional breach. In such cases, any exception to the limitation of foreseeability should be considered as a matter of risk allocation between the parties, which must be ascertained on the basis of the terms of the contract and the surrounding circumstances, since it relates to the determination of whether the non-performing party can be considered as having assumed the risk that, when it decides to breach the contract intentionally, it will have to bear the full loss incurred by the aggrieved party regardless of its foreseeability.

Unless, the non-performing party can be considered as having assumed such a risk under the risk allocation articulated in terms of the contract and default rules chosen by the parties, or implied from the surrounding circumstances through a contextual approach, its intentional or greatly negligent breach should only be considered as a factor relaxing the requirement of certainty with regard to proving the existence of the loss, in order not to reward the party in breach by depriving the other party of compensation merely because of the uncertainty as to the existence of the loss. However, the element of intentional or negligent breach should not be considered as an exception of the foreseeability, in the form of an established rule in the order of international commerce.

3. Certainty

Another limitation in the form of an established rule in the order of international commerce is that damages will be awarded only for the loss that is proven by the aggrieved party with a reasonable degree of certainty. This limitation will rather be relevant to the existence of loss, than its extent, since the basic principle of good faith and fair dealing under *lex mercatoria* will not allow a party in breach to escape from liability for damages merely because no precise basis for determining the extent of damages exists. Once the existence of loss is established, the decision maker applying *lex mercatoria* will rely on its estimate as to the extent of damages, even if it cannot be established with a sufficient degree of certainty. Thus, where there is considerable uncertainty as to the determination of the extent of damages, the decision maker will assume the task of controlling that uncertainty, usually by means of the

²⁹¹⁵ *Ibid.*, at 103

²⁹¹⁶ Gordley, James, *The Foreseeability Limitation on Liability in Contract*, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, C.E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 226

default rules applicable in the case or by the established rule of certainty, rather than rejecting to award damages for the existing loss.

In ICC Case No. 8362, the sole arbitrator considered the issue of certainty of claimant's claim for lost profits arising from the unlawful termination of its exclusive distributorship agreement by the defendant. The parties agreed that some standard of certainty must be met, under the applicable New York law, with respect to (i) the causal link between the breach and the alleged damages, and (ii) the amount of damages claimed to have been suffered. However, the parties disagreed as to what the applicable standard of certainty was and whether that standard had been met. The arbitrator stated that, under New York law, the claimant must show “(i) that it has suffered harm, (ii) that such harm was caused with certainty by the breach, and (iii) that the amount of its damages is established with reasonable certainty” The arbitrator determined that as the right to resell at a profit was what was contemplated by the parties upon concluding the agreement, the loss of profit suffered from the withdrawal of that right was clearly within the contemplation of the parties. According to the arbitrator, the damages incurred by the claimant directly flowed from the breach, which was the immediate and proximate cause thereof. Thus, the arbitrator held that the claimant established with certainty that it suffered a loss and that such loss resulted from the breach of the distributor agreement.²⁹¹⁷ With respect to the calculation of damages, the arbitrator noted that while the amount of damages cannot be the product of sheer speculation unsupported by tangible evidence, the law will not reward a party in breach by depriving the other party of compensation merely because no precise basis for determining the amount of damages exists. After calculating the avoided cost, the arbitrator calculated the lost net profit as a percentage of the estimated lost sales equal to gross margin less avoided cost. With respect to the time period to which lost profits related, the arbitrator determined the earliest possible date for the exercise of defendant’s right to terminate under the agreement, and assumed the agreement would have been terminated as of that date.²⁹¹⁸

The requirement of certainty is particularly relevant to the recovery of lost profits. The arbitral tribunal in ICC Case No. 8445 found that a German manufacturer, the defendant, breached a technology licensing agreement with an Indian manufacturer, the claimant, by failing to provide the claimant with certain documents as provided for in the agreement. The claimant requested damages for lost profits. The tribunal first noted that the applicable law, the Indian Contract Act, provided that, “in order to recover for breach of contract, the aggrieved party must show that such damage arose naturally in the usual course of things from such breach, or was damage which the parties knew when they made the contract would be likely to result.”²⁹¹⁹ The tribunal found that the claimant’s loss of profits arose naturally from the respondent’s breach of the agreement, on the ground that “the claimant unquestionably expected to make a profit from the local manufacture and sale of products, and its inability to do so naturally led to a loss of profits, a result which both parties must have known at the time they entered into the Agreement.” The tribunal then rejected the defendant’s argument that the claimant failed to provide adequate proof of loss. The tribunal stated that under “Indian jurisprudence, an injured claimant is not required to prove the amount of damage with absolute certainty, where such certainty is not possible, as is in the case of lost profits, and ... [all that is required] is a reasonable estimate of loss, based on such elements as are

²⁹¹⁷ ICC Award in Case No. 8362, 1995, Yearbook Commercial Arbitration, 22 (1997), at 176

²⁹¹⁸ *Ibid.*, at 177

²⁹¹⁹ ICC Final Award in Case No. 8445, 1996, Yearbook Commercial Arbitration, (2001), at 175

available.”²⁹²⁰ The tribunal determined that the claimant met this requirement by providing detailed and reasoned estimates of the costs of manufacturing the products, the prices at which they could be sold, its prospective market share and projected sales growth, and the ensuing profit that would have been made. The tribunal awarded the claimant lost profits for the duration of the agreement, but discounted by 15% to take into account the “uncertain nature of the calculations.”²⁹²¹

In ICC Case No. 7181, the arbitral tribunal awarded damages for lost profits, which was based on the ground that the useful life of the agreement was diminished. The case concerned a joint venture agreement concluded in 1985 between two software designers for the development, marketing and support of software packages to build an interface device, allowing concurrent use of banking applications. The agreement provided that a Common Software Environment (also referred to as the Central Part) would be jointly maintained and shared by the parties to support the defendant’s Software 1 and Software 2 as well as the claimant’s payment system software. In 1990, the claimant was informed of the development of Release 5 of Software 1 by the defendant. The claimant complained that the changes made to Software 1 violated “the provision (of the Agreement) for maintaining a Central Part of the software common to the Software 1 and the claimant’s system”. Although the claimant disagreed with the development of Release 5, the defendant announced its issuance and initiated its marketing. The claimant refused the implementation of the short-term integration plan, which was agreed upon by the claimant and the defendant in a meeting in 1991. This led to the interruption of the claimant’s commercial efforts, because after the development of Release 5, the claimant’s customers could not rely on access to the future releases of Software 1. The arbitration clause provided for the application of Belgian law.²⁹²²

The parties indicated the possibility of appointing an expert to look into this question of damages for the claimant’s loss of part of the agreement’s useful life. In the opinion of the arbitral tribunal, this question required an assessment, firstly, of the period during which the claimant could not avail itself of the benefits of the agreement, and secondly, of the number and profitability of transactions claimant would have been able to enter into during that period. The arbitral tribunal maintained that while the first assessment was linked to an appreciation of the behavior of the parties, the second was of a factual nature and an expert appraisal could not give the arbitral tribunal precise elements of valuation of these factors. Thus, the tribunal preferred, rather than appointing an expert, to determine, without further delay, the amount of damages *ex aequo et bono* under Belgian law, which entitles the judge to “assess the damage *ex aequo et bono* provided that, as in this case, he indicates why the assessment proposed by the parties cannot be accepted and why the damages can only be assessed *ex aequo et bono*.”²⁹²³ “Taking into account, on the one hand, the average number of claimant’s new clients since the implementation of the joint venture agreement, and on the other hand, the time necessary after the announcement of Release 5, to reach agreement on restoration of the integration and then to implement the 1991 short-term integration plan and for claimant to take up again its interrupted commercial effort”, the tribunal determined *ex aequo et bono* the amount of compensation. The tribunal rejected the claimant’s other claims for out-of-pocket expenses, software technology and client base as these contributions were

²⁹²⁰ Ibid.

²⁹²¹ Ibid., at 176

²⁹²² ICC Award in Case No 7181, 1992, Yearbook Commercial Arbitration (1996), at 104

²⁹²³ Ibid., at 111

made by the claimant in furtherance of the agreement, and the claimant did not call for termination of the agreement and was being compensated for the loss of part of the agreement's useful life.²⁹²⁴

Although the decision makers applying *lex mercatoria* should be reluctant to provide compensation for losses with inherently speculative elements, they should consider the fact that, in the order of international commerce, the parties enter into an agreement with a view to making a profit, and the aggrieved party's loss of profits or loss of opportunity to make profit can be a direct and foreseeable consequence of the non-performance. Particularly, in the case of a loss of opportunity to make profit, the decision maker applying *lex mercatoria* should consider awarding damages in proportion to the probability of its occurrence in its discretion.

In ICC Case No. 8331, where the claimant was found to be in breach of its obligations to exert its best efforts in respect of forming and establishing with the respondent the assembly of the claimant's vehicles in Iran, the tribunal, applying UNIDROIT Principles, stated that "the damages suffered by the Respondent in that respect may not be accurately determined due to the fact that they relate to assumptions on what would have been the benefit for the Respondent." Referring to Article 7.4.3 of UNIDROIT Principles, the tribunal considered that the claimant should compensate the respondent for the loss of the chance to enjoy the probable benefits of the two aborted projects, and the respondent was legally justified in calling the performance guarantee, being payable on demand, and covering the good execution of the claimant's contractual obligations. The tribunal, by exercising its discretionary power, determined the amount of damages, but, as it was lower than the amount of performance guarantee already cashed by the respondent, the tribunal ordered the respondent to reimburse the balance to the claimant.²⁹²⁵

In ICC Case No. 8423, two Portuguese companies, the claimants, entered into an association agreement with a subsidiary of a French company, the defendant, for the purpose of exploitation of certain plants through a jointly owned company. The claimants claimed that the defendant breached the noncompetition agreement by submitting offers for the construction and exploitation of four separate projects in which the joint company was also interested. The tribunal noted that, under the applicable Portuguese law, contractual liability presupposes a wrongful failure to perform an obligation, damage and causal relationship between the wrongful failure to perform and damage.²⁹²⁶ The tribunal held that, while the defendant violated the noncompetition clause, there was no causation between the joint company's claimed damage and the defendant's wrongful participation in the first three projects since the joint company did not submit bids to participate in those projects and failed to prove it had the ability to do so or would have done so. However, with respect to the fourth project, the tribunal held that adequate causation existed because the joint company did submit an offer for that project. While the tribunal noted that it could not "affirm with certainty that [the joint company] would have obtained the contract if the defendant French parent company had not submitted an offer", the defendant's action "was such as to diminish, according to the ordinary course of things and general business experience, the chance of success of the submission by the [joint company]"²⁹²⁷. Although the tribunal noted that it was

²⁹²⁴ Ibid., at 112

²⁹²⁵ ICC Award in Case No. 8331, 1996, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 68

²⁹²⁶ ICC Final Award in Case No. 8423, 1994, Yearbook Commercial Arbitration, (2001), at 161

²⁹²⁷ Ibid., at 165

“difficult to assess [the joint company’s] loss of opportunity to the French parent company’s breach of contract”, in part, because the claimants “failed to submit sufficient evidence of [their lost] profit”, it awarded the claimants as damages what it estimated to be the claimant’s share of the loss of possible profit.²⁹²⁸

Even if the applicable national law does not explicitly enable the decision maker to award damages on the basis of the loss of opportunity to make profit, the decision maker applying *lex mercatoria* will be able to award such damages by exercising its discretionary power on the basis of the rules of the applicable law relating to the assessment of damages, as long as the existence of such loss can be proven with reasonable certainty by the aggrieved party. However, in cases where the national law chosen by the parties explicitly denies awarding such damages, the decision maker should consider the relevant rules of the applicable law as part of the bargain between the parties, and as limiting the recoverable amount of damages.

In ICC Case No. 9078, the claimant argued that the defendant violated their agreement under which the defendant was required to transfer to the claimant all know-how concerning the licensed product and to stop manufacturing and selling that product and to cancel an agreement with an existing licensee. The claimant requested damages for lost opportunities on the ground that the defendant allowed its existing licensee and another company, which it had an interest, to continue manufacturing equipment and machinery using the licensed know-how, enabling them to make a number of orders, which would otherwise have gone to the claimant. The parties designated German law as the governing law of the contract. The claimant based its damage claim on the assumption that the sub-licensees of the claimant would have been able to enter into contracts for the supply of the relevant equipment and machinery to the named purchasers if the defendant had not offered and supplied the corresponding machinery and equipment to such potential customers. The tribunal considered that the basis of this claim was an assumption of a probability of lost profits, which, by its very nature, could not be proven in the strict sense of legal evidence. In the tribunal’s view, the claimed damage was actually “a *damage for a lost opportunity*, respectively the value of the missed chance or opportunity of concluding a deal and realising a profit on such deal”.²⁹²⁹

The tribunal stated that the claimant did not submitted materials which would support the existence of clear rules under German law as to how damages for lost opportunity should be dealt with, and the tribunal could not find such rules clearly established by learned authors or precedents. However, according to the tribunal, it must be admitted that damage resulting from lost opportunities is real damage and the possibility to claim the compensation of such damage caused by a breach of contract must be upheld. In this regard, the tribunal referred to French and Swiss laws and to the UNIDROIT Principles, all of which recognized the principle of compensation for harm suffered as a result of a lost opportunity and allowed a certain degree of judicial discretion in the assessment of the damages. The tribunal also stated that it had not become aware of any opinions under German law to the effect that the principles should not apply in Germany. The tribunal noted that since, in such circumstances, neither the actual occurrence of the damage nor the extent of the potential damage could be strictly proven, the damages to be awarded must be assessed by a tribunal based on the degree of probability for the realization of the opportunity and based on a likelihood of the profit margin which might have been obtainable by the claimant on the lost transaction. According

²⁹²⁸ Ibid., at 166

²⁹²⁹ ICC Award in Case No. 9078, October 2001, ICC International Court of Arbitration Bulletin, Special Supplement: UNIDROIT Principles: New Developments and Applications, (2005), at 75

to the tribunal, although strict evidence was not possible, sufficient proof had to be required from the claimant to demonstrate at least a very high probability for three elements: “(i) the loss of the business, (ii) the causal nexus between the breach of the contractual obligation by Defendant and the loss of the transaction, and (iii) for the net profit which the Claimant could have realised on the lost transaction.” The tribunal concluded that “Since the award of damages in such circumstances is ultimately based on the degree of probability of certain assumptions, the Arbitral Tribunal has to assess the degree of probability of the loss of opportunity and of the lost profit. This necessarily implies a certain range of discretion for the valuation to be made by the Arbitral Tribunal when deciding on the damages to be awarded.”²⁹³⁰

4. Mitigation

In the doctrine, there is a general consensus that the principle of mitigation of loss has become a general principle of law.²⁹³¹ It is argued that even arbitrators applying national law, which does not expressly recognize the duty to mitigate, understand that it is part of the transnational law of commerce.²⁹³² Alternatively, it is suggested that the principle that the victim of a breach of contract cannot recover damages in respect of a loss that he ought to have avoided by taking reasonable steps is clearly recognized in practically all legal systems.²⁹³³ Indeed, it can be easily observed that there is a general tendency of arbitrators to take into account the principle of mitigation of loss whenever, an issue related to it arises in the proceedings and, thus, it has been consistently applied in the arbitral awards.²⁹³⁴

A number of tribunals have considered it as a general principle, without referring in particular to a national legal system.²⁹³⁵ For example, in ICC Case No. 2478, the arbitral tribunal stated

²⁹³⁰ Ibid., at 75-76

²⁹³¹ Lowenfeld, Andreas F., *Lex Mercatoria: An Arbitrator's View*, Arbitration International, (1990), at 148; Molineaux, Charles, *Moving Toward a Lex Mercatoria - A Lex Constructionis*, Journal of International Arbitration, 14-1 (1997), at 65; Mustill, Michael, *The New Lex Mercatoria: The First Twenty-five Years*, Arbitration International, (1988), at 113; For the reluctant view, see Tallon, Denis, *Damages, Exemption Clauses, and Penalties*, American Journal of Comparative Law, 40 (1992), at 680

²⁹³² Carbonneau Thomas E., *A Definition of and Perspective upon the Lex Mercatoria Debate*, in Thomas E. Carbonneau (ed.), *Lex mercatoria and arbitration: a discussion of the new law merchant*, Kluwer Law International, Rev. ed., 1998, at 18

²⁹³³ Komarov, Alexander S., *Mitigation of Damages*, in Yves Derains & Richard H. Kreindler, (eds.), *Evaluation of Damages in International Arbitration*, ICC Publication No. 668, 2006, at 39

²⁹³⁴ Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 646; Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 832

²⁹³⁵ E.g., ICC Award in Case No. 2142, *Yearbook Commercial Arbitration*, (1976), at 132-133; ICSID Award, *AMCO Asia Corp. et al. v. The Republic of Indonesia*, *Yearbook Commercial Arbitration*, (1992), at 97; ICC Award in Case No. 2103, 1972, *Yearbook Commercial Arbitration*, (1978), at 219; ICC Award in Case No. 3880, *Yearbook Commercial Arbitration* (1985), at 46; ; The duty to mitigate was also pronounced and applied by the Iran US Claims Tribunal in a number of awards: *Ford Aerospace & Communications v. Iran*, Partial Award of 29 January 1987, 14 Iran-US CTR 24, at para 46, 71-72; *Watkins-Johnson v. Iran*, Award of 28 July 1989, 22 Iran-US CTR 244, at para 95; *General Electric Company v. Iran*, Award of 15 March 1991, 26 Iran-US CTR 148, at para 43; *Alan Craig v. Ministry of Energy of Iran*, Award of 2 September 1983, 3 Iran-US CTR 280, at 289; *Ram International Industries v. Iran and the Islamic Republic of Iran Air Force*, Award of 9 May 1991, 26 Iran-US CTR 228, at para. 34-35; *World Farmers Trading v Government Trading Corporation et al*, Award of 7 July 1989, 22 Iran-US CTR 204, at para 22; *Varo International Corporation v. Iran*, *Iran Electronics Industries, Ministry of National Defence*, Award of 21 June 1990, 25 – Iran-US.CT.R. 3, at para. 37

that “it must not be forgotten that under the general principles of law, which moreover are reflected in Articles 42, section 2, and 44, section 1 of the [Swiss] Federal Code of Obligations, it is up to the injured party to take all necessary measures so as not to increase the injury.”²⁹³⁶ In an ICSID Award, the tribunal stated that “The duty to mitigate damages is not expressly mentioned in the BIT. However, this duty can be considered to be part of the General Principles of Law which, in turn, are part of the rules of international law which are applicable in this dispute according to Art. 42 of the ICSID Convention.”²⁹³⁷ In ICC Case No 10346, the tribunal, applying Colombian law, stated in a footnote that “[the principle that the reparation for the loss cannot impose exaggerated burdens on the liable party], which is firmly rooted in the *lex mercatoria*, is contained in article 7.4.8 of the *Unidroit Principles*... The purpose of this article is to avoid the aggrieved party passively sitting back and waiting to be compensated for harm which it could have avoided or reduced. Any harm which the aggrieved party could have avoided by taking reasonable steps will not be compensated. Evidently, a party who has already suffered the consequences of non-performance of the contract cannot be required in addition to take time-consuming and costly measures. On the other hand, it would be unreasonable from the economic standpoint to permit an increase in harm which could have been reduced by the taking of reasonable steps. The steps to be taken by the aggrieved party may be directed either to limiting the extent of the harm, above all when there is a risk of it lasting for a long time if such steps are not taken (often they will consist in a replacement transaction: see art. 7.4.5), or to avoiding any increase in the initial harm.”²⁹³⁸

In the abstract reasoning of the decision maker applying *lex mercatoria*, the issue of mitigation of loss will firstly arise, when the aggrieved party can be considered as having failed to perform its specific or residual contractual obligations relating to the period after the non-performance by the other party. Such contractual obligations may arise from the contract, the chosen default rules or trade usages in the narrow sense, or within the confines of the contextual approach to the supplementation of the contract with individualized terms. However, they should not be implied by the decision maker solely on the basis of an abstract conception of good faith, which would neglect or disturb the equilibrium of contract by creating costs that cannot be considered as reasonable.

In an award rendered under the German Coffee Association, the tribunal found a trade usage including the obligation to mitigate loss and applied such usage directly and without any discussion of the applicable law. In the case, the buyer received a shipment of coffee from the seller that did not correspond with the quality description in the contract. According to Hamburg coffee trade usage, the buyer should then have determined the price of the agreed goods at the time of the incorrect performance by making a “coverage deal”, i.e. by buying a certain quantity of coffee of the contractually agreed quality. However, due to a temporary lack of suitable coffee on the market, the buyer bought coffee of a higher quality. The buyer also sold the coffee supplied by the seller to a third party and claimed damages in arbitration for the lower price he obtained for it. The tribunal found that, while it was acceptable for the buyer to buy higher quality coffee for a coverage deal if there was a shortage of suitable coffee on the market, “the buyer breached its obligation under the Hamburg usages by failing

²⁹³⁶ ICC Award in Case No. 2478, 1974, *Yearbook Commercial Arbitration*, (1978), at 223

²⁹³⁷ *Middle East Cement Shipping v. Arab Republic of Egypt*, ICSID Case ARB/99/6, Award, April 12, 2002, para. 167

²⁹³⁸ ICC Award in Case No. 10346, December 2000, *ICC International Court of Arbitration Bulletin*, 12-2 (2001), at 114

to mitigate damages and to inform the seller of its intention to re-sell the coffee to a third party”, as the seller was thus incapable of “influencing the sale and the sale's timing”.²⁹³⁹

In ICC Case No 5073, the tribunal, applying the laws of California, considered that the aggrieved party could have mitigated its loss arising from the abrupt termination of the other party by negotiating with the latter, which had made a reasonable offer to continue with their contractual relationship after the termination. The case concerned an agreement, under which the claimant, a US exporter, appointed the defendant, an Argentine distributor, as its distributor for the sale of certain products in Argentina. The agreement originally provided for a duration of two years, but the parties entered into several short term extensions. The claimant informed the defendant that claimant was in the process of updating the agreement and that it would be a few months before the new instrument was completed. Thus, the claimant extended the existing agreement until two months after the claimant should present the defendant the new one, thus allowing time for the latter to consider it. However, the new agreement was never submitted to the defendant. In the meantime, the claimant wished to appoint another company, better qualified in its judgment, to act as partner and distributor, so decided to terminate the existing agreement with the defendant upon two months’ notice. The claimant filed a request for arbitration seeking an award declaring that the original agreement had been properly and effectively terminated. The original agreement provided that it shall be governed by the laws of California.²⁹⁴⁰

The tribunal found that the claimant extended the agreement for an indefinite period of time, as it would expire two months after the unspecified moment of presentation to defendant of a new agreement. Thus, either party could terminate the agreement of indefinite duration without a good cause provided that a reasonable length of time has elapsed and sufficient notice is given to the other party.²⁹⁴¹ However, the tribunal also noted that the claimant’s actions raised the defendant’s expectations about the prospect of a long term relationship, and thus, the claimant could not plausibly maintain the same degree of freedom in terminating the relationship as if those actions had not taken place. The tribunal held that the claimant’s termination of the contract upon two months’ notice was unreasonably abrupt.²⁹⁴² However, the tribunal believed that the offer of the claimant, sent after its abrupt termination, to extend the existing agreement upon the same terms and conditions as in the past constituted a good faith and reasonable proposal to continue performing under the original contract. According to the tribunal, upon receipt of the offer, the defendant could have expressed any specific objections to its terms, thus allowing the claimant to consider modifications of its offer. However, the defendant chose to regard the offer as absolutely unacceptable and malicious, and expressly rejected it. In this context, the tribunal considered that the defendant was entitled to compensation for the loss resulting from the abrupt notice of termination, though presumably only for the loss or damages suffered as of that period of time ending when the defendant improperly rejected the offer of delayed performance.²⁹⁴³ The tribunal found this result in conformity with the rule of California law on mitigation of damages. The tribunal stated “That rule required defendant to mitigate the damages flowing from claimant’s abrupt termination of the contract. At a minimum, it appears that claimant’s offer ... to renew the

²⁹³⁹ German Coffee Association, Final award of 13 July 1998, Yearbook Commercial Arbitration, (2000), at 216

²⁹⁴⁰ ICC Partial Award in Case No. 5073, 1986, Yearbook Commercial Arbitration, (1988), at 53-57

²⁹⁴¹ Ibid., at 62

²⁹⁴² Ibid., at 62-63

²⁹⁴³ Ibid., at 67

contract for two years presented defendant with an appropriate opportunity to mitigate its damages. The tribunal believes that it would be unfair for one of the parties to deny the other the opportunity to correct a certain situation created by its improper conduct.”²⁹⁴⁴

Thus, the duty to mitigate the loss will be specified in the particular circumstances of the case, as an instance of the general duty to cooperate, such as the duty to inform the other party after non-performance by the other party, or the duty to consider a reasonable offer by the non-performing party to cure its breach. However, the failure of the aggrieved party to cooperate relating to the period subsequent to the non-performance for the mitigation of its loss will not grant the non-performing party an affirmative claim. The decision maker will take into account such failure of the aggrieved party in determining the recoverable amount of damages. This is because the issue of mitigation of loss can be considered, at an abstract level, as an instance of the application of causality, which requires decision maker to ascertain to what extent the aggrieved party’s failure to perform its specific or residual obligations relating to the period subsequent to the non-performance by the other party can be considered as the cause of the loss incurred by the aggrieved party.

The causality component in the issue of mitigation becomes more apparent in such cases that the aggrieved party is required to seek substitute performance. This implies the consideration of the ordinary course of events by the decision maker in order for him to determine whether the aggrieved party is under a duty to mitigate through the concept of reasonableness. In the going order of actions in the context of international commerce, the non-performing party may reasonably expect that aggrieved party will continue with its business after the non-performance, and will not remain idle for excessive periods on the sole ground of non-performance. Thus, the decision maker should take into account that the risk of the aggrieved party’s prolonged inactivity in the order of international commerce may not be considered as being fully assumed by the non-performing party, unless it is explicitly provided so in the contract, or that risk can be residually allocated by the decision maker on the basis of the consideration of ordinary course of events in the order of international commerce. In this sense, the duty to mitigate requires that the aggrieved party take such measures as are reasonable in the circumstances, while excluding such measures that, although they may mitigate the loss, exceed reasonable expectations in the circumstances. Thus, the risk of prolonged inactivity of the aggrieved party may be allocated to the non-performing party to the extent that non-performance creates unreasonable costs for the aggrieved party to proceed with its ordinary business, such as when substitute performance cannot be obtained through the aggrieved party’s ordinary conduct of business due to highly transaction-specific investments or other interdependencies²⁹⁴⁵, or where the breach itself destroys the business of the aggrieved party, or substantially deprives the aggrieved party of its ability to conduct its business in an ordinary manner²⁹⁴⁶.

²⁹⁴⁴ Ibid., at 68; The tribunal decided to deal with the question of how the damages that allegedly ensued from the wrongful termination should be measured or mitigated, in the final award upon collecting all the evidence.

²⁹⁴⁵ Cafaggi, Fabrizio, *Creditor’s Fault: In Search of a Comparative Frame*, EUI Working Papers Law No. 2009/15, available at <http://ssrn.com/abstract=1551825>, at 1, 6: In these circumstances, the difficulty to find alternative performances and the ‘unreasonable’ mitigation through cover may give rise to the residual obligation of the aggrieved party to negotiate with the non-performing party, in order to find alternative solutions within the contractual relationship.

²⁹⁴⁶ In a state party dispute, the breach by the state party of its treaty or contract obligations may lead to the consequence that the issue of mitigation of loss by the investor may not be sustainable by the state party. This can be exemplified by the *Amco II Award*. In April 1980, the hotel, which was the investment of Amco in Indonesia, was seized in an armed military action and the management effectively taken over by P.T. Wisma, a

ICC Case No 5885 concerned two sales contracts under which the claimant was to provide two cargoes of a commodity and the defendant was to provide confirmed letters of credit within a certain time. The claimant, however, rejected the letters of credit offered by the defendant on the ground that they were not rectified within the time stipulated in the contract. The claimant terminated the contracts and claimed damages for non-performance. The sole arbitrator ruled that the dispute should be resolved according to the English law, and held that the contracts had been rightfully terminated due to the lack of confirmed letters of credit. The arbitrator found that the market price of the commodity rose subsequent to the claimant's termination of the contracts. Thus, the tribunal considered that a seller having terminated a contract of sale for the commodity would normally benefit from the rising market and be able to avoid a loss of the kind which claimant alleged to have suffered. The arbitrator stated that "claimant, in a rising [commodity] market, should have been able to avoid any financial loss resulting from their termination of the contracts by making better use of the firm offer from the [supplier] which, I conclude, had not expired at the time when claimant terminated the contracts with defendant. Thus, I cannot find that claimant has met its burden of proving that, in spite of the rising market price of [the commodity], they were unable to avoid the loss of profit allegedly resulting from the termination." Nevertheless, the arbitrator found it probable that the claimant may have been unable to avoid every loss resulting from the termination. The arbitrator awarded damages to the claimant, apparently on the basis of a discretionary assessment. The arbitrator considered that the claimant at least must have incurred substantial expenditure and loss of time for contracts, which they were entitled to terminate and did lawfully terminate because of defendant's breach.²⁹⁴⁷

In ICC Case No. 8817, the dispute arose from the unlawful termination of an agreement for the exclusive distribution and sale of food products between a Spanish company, as distributor, and a Danish company, as principal. The arbitrator considered that the CISG and its principles, as elaborated in the UNIDROIT Principles were perfectly suited to resolving the dispute and the provisions of the contract, being the law of the parties, should apply.²⁹⁴⁸ The arbitrator held that, as the grounds invoked by the principal to justify the termination without notice of the exclusive distributorship agreement was not legally valid, the principal should have observed the one-year notice, as provided by the contract, before terminating the

company under the control of a cooperative established under Indonesian law for the welfare of active and retired Indonesian Army personnel. On 9 July 1980, the Indonesian Capital Investment Board (BKPM) revoked Amco's Foreign Capital Investment Licence. BKPM's decision caused Amco to lose its licence to engage in business ventures in Indonesia, but did not in terms cause Amco to lose all its rights under some contracts. Indonesia contended that Amco could still have sold its interests in these contracts to a third party and should indeed have done so, to mitigate any loss sustained by the decision to terminate its licence. Indonesia argued that both Indonesian and international law pointed to such a duty to mitigate damages. Amco did not contest that Indonesian law and international law both acknowledge the principle of mitigation, but claimed that there was no realistic prospect of it being able to mitigate its loss. The tribunal considered that the events that had occurred since the beginning of April 1980 would have made it virtually impossible to find interested purchasers. Thus, the tribunal found that there was no failure on PT Amco's part to mitigate damages. Final award of 5 June 1990 in case no. ARB/81/8 and Decision on Supplemental Decision and Rectification of 17 October 1990, ICSID Award, AMCO Asia Corp. et al. v. The Republic of Indonesia, Yearbook Commercial Arbitration, (1992), at 97 para. 78-79; Even so, it is observed that international investment law generally recognizes the duty of mitigation and that failure to comply with this duty, if upheld by a tribunal, will have a limiting effect on the amount of recoverable damages. Ripinsky, Sergey, & Kevin Williams, *Damages in International Investment Law*, London: British Institute of International and Comparative Law, 2008, at 322-325

²⁹⁴⁷ ICC Award in Case No. 5885, Yearbook Commercial Arbitration, (1991), at 95-96

²⁹⁴⁸ ICC Award in Case No. 8817, 1997, Yearbook Commercial Arbitration, (2000), at 359

contract.²⁹⁴⁹ The agent claimed lost annual profits in damages for having been unable to distribute the principal's products. The arbitrator held that the agent may claim an indemnity of one year of profit, being the notice period, and one year of fees.²⁹⁵⁰ The agent also claimed damages on the ground that, failing deliveries by the principal, the agent could not manufacture and sell certain compound products. The arbitrator found that the sudden, unexpected interruption of deliveries caused damages to the distributor, consisting in the form of difficulties in adapting to a new situation requiring changes in manufacturing arrangements. However, the arbitrator noted that the distributor did not prove that this difficult situation lasted one year, and that it did not supply any proof of its endeavors to solve this situation or of its difficulties in adapting to new conditions and products. The arbitrator agreed with the principal's argument that it is one of the principles of European commercial law that the damaged party must take all necessary measures to mitigate its damage. Thus, referring to Article 77 of the CISG, and Article 7.4.8 of the UNIDROIT Principles, the arbitrator concluded that, in the absence of evidence of efforts made by the distributor during the alleged year of inactivity, economic inactivity was partly due to the distributor's inertia.²⁹⁵¹

While the most common reasonable measure, for an aggrieved party proceeding with its ongoing business, to mitigate its loss is a substitute arrangement, the decision maker may find that an adequate substitution would not be reasonable as a means of mitigating the loss in the particular circumstances of the case. In ICC Case No 5418, the parties designated Hungarian law as the applicable law to their agreement under which, the Hungarian exporter granted the English importer the sole and exclusive rights for the import and sale in the territory of the United Kingdom of certain Hungarian wines. The English exporter claimed for damages consisting of loss of profits, which resulted from the wrongful termination of the agreement by the Hungarian exporter. The tribunal referred to Section 340(1) of the Civil Code, which provided that "The injured person shall make such effort in order to prevent or to mitigate the damages as might reasonably be expected generally in the given situation. Such part of the damages as has been caused by the injured person having omitted to comply with the said duty does not entitle him to compensation." The tribunal was of the view that the English importer was not acting unreasonably in declining to attempt to expand their sales of Hungarian generic wines. The tribunal accepted the evidence that the importer could not substantially increase sales of generic wines and to have any chance of increasing such sales would have required the launching of a new brand, which would have involved a very substantial capital investment presented by promotion costs, with great uncertainty as to likely degree of success. The tribunal considered that the prospects of increased sales of generic wines were so uncertain and the capital expenditure in launching them was so great that the claimants were quite justified in refusing to take the risk of losing their capital in proceeding with their ongoing business. Thus, the tribunal held that there was no breach of the duty to mitigate.²⁹⁵²

In a case decided under the auspices of Stockholm Chamber of Commerce, the claimant and the defendant concluded an agreement for the manufacture of industrial batteries in China. Under the agreement, the claimant granted to the defendant a twenty year exclusive license to

²⁹⁴⁹ Ibid., at 363

²⁹⁵⁰ Ibid., at 366

²⁹⁵¹ Ibid., at 367

²⁹⁵² ICC Award in Case No. 5418, 1987, Yearbook Commercial Arbitration, (1988), at 101

sell and distribute the products which it would manufacture to entities within China, while the claimant held the exclusive right to market the products outside of China. The agreement placed the responsibility for the setting up of the new factory on the defendant, but the defendant failed to do so. The claimant urgently needed delivery of the batteries because of the termination of a contract with another supplier. Thus, the claimant terminated the agreement and requested damages. The contract did not contain a choice of law clause, and the arbitral tribunal decided to apply Chinese law to the substance of the dispute. The tribunal stated that, “under Chinese law, the liability for damages in a breach of contract situation is based on the principle that the party breaking the contract is liable to pay compensation to the other party in an amount equal to the actual loss suffered by the latter. That liability does, however, not go beyond what was a foreseeable loss at the time of the conclusion of the contract. The Tribunal also understands that the claiming party under Chinese law has a duty to mitigate its actual losses as far as possible.”²⁹⁵³

The claimant calculated the actual losses on the basis of detailed forecasts of expected results during the relevant time period, including the forecasted production capacity of a factory that the respondent failed to complete, and the forecasted sales of the product that was to be made at the factory, which were based largely on statements from the claimant's customers that they would have bought certain quantities of the product at prices that were competitive with those offered by the claimant's competitors. The tribunal accepted “that the claimed amount of loss of profit fairly represents what the claimant would have earned during the relevant period of time, if production according to the Agreement had been performed.”²⁹⁵⁴ The tribunal then considered whether, during this period, the claimant could have procured replacement supplies of similar batteries and thereby mitigated the loss. The customer witnesses and other witnesses testified that such possibilities did not exist, since no existing factory was prepared to supply such batteries to the claimant at prices making profitable a resale to the claimant's purchasers, who all manufacture or market assembled batteries, due to production costs, environmental constraints, competitive factors and other reasons. The witnesses stated that the only alternative method was to wait for a new factory to be established in the same way as the factory figuring in the agreement underlying the dispute. The claimant actually had chosen that solution, but it necessarily took a lot of time to achieve such a resolution of the problem. The tribunal concluded that the claimant could not provide replacement supplies earlier than it did and, thus, its claim for lost profits included the period until the time the supplies from the new factory would likely commence.²⁹⁵⁵

Under these considerations, even if the applicable national law does not formally recognize a doctrine of mitigation of damages, the decision maker applying *lex mercatoria* may enforce a specific duty to mitigate, where it is provided by the contract, or imply a residual duty to mitigate from trade usages in the narrow sense in the particular circumstances of the case. Moreover, in the absence of specific or residual allocation of the risk of prolonged inactivity of the aggrieved party to the non-performing party, a certain part of damages may be considered as being remote and unforeseeable and, thus, may not be recovered by the aggrieved party as its failure to mitigate its loss, even if the applicable national law does not recognize such a duty.

²⁹⁵³ SCC Final Award, July 13, 1993, Yearbook Commercial Arbitration Volume, (1997), at 208

²⁹⁵⁴ *Ibid.*, at 209

²⁹⁵⁵ *Ibid.*

In ICC Case No. 7006, the arbitrator applied the rules on the foreseeability and directness of damages under French law, which was applicable pursuant to the choice of the parties, and reached the conclusion that the damages resulting from the failure of the aggrieved party to mitigate its loss were irrecoverable. In the case, the supplier argued that the distributor breached the distribution agreement, by terminating it illegally and ceasing its distribution activities before the date on which the supplier was definitely informed about the discontinuation of the distribution. The agreement was concluded for a three-year term commencing July 1987. The arbitrator found that the distributor ceased to distribute the product from at least as early as March 1988, and no sales were made through normal distribution channels until September 1988, when the distributor definitely advised the claimant that it was discontinuing distribution of the product and it would no longer continue to represent the supplier.²⁹⁵⁶ Applying the principles of French law, the arbitrator held that the damages to which the supplier was entitled must be direct and foreseeable consequences of the distributor's breach. In arbitrator's view, the claimant needed sufficient time for itself directly or through other distributors indirectly to re-attain the relatively modest level of sales which the defendant had reached. The supplier did not make a single sale of the products in the designated market between April 1988 and March 1990. The arbitrator concluded that one year from the time that claimant was apprised of the defendant's decision not to continue with the contract, i.e. until September 1989, would have been sufficient time for it to achieve the status quo ante, and the beginning point of its loss of profits should be March 1988.²⁹⁵⁷

In other words, the arbitrator found that the supplier could have mitigated its losses after September 1989 and, thus, it did not award the portion of the lost profits it claimed relating to the period between September 1989 and the date of expiration of the contract, i.e. July 1990. Thus, the measure of the supplier's lost profit was determined as what it would have realized until one year after it received formal notice of termination if the distributor had continued to sell inventory of the same category and at the same rate as it did during the period of contract's performance until March 1988, and had replaced the inventory by additional purchases assuming the continuance of the supplier's price and its gross profit margin. On the other hand, the arbitrator considered the direct costs, such as sale promotion allowances, contribution to the salary of the principal employee of the distributor in charge of developing the market for the product and publicity and labeling expenses, as a loss to the supplier which was caused by the defendant's breach. According to the arbitrator, the contract was short lived and the distributor's sales volume so meager that it may be assumed that the supplier would never have chosen to incur these costs had they foreseen the outcome. The tribunal concluded that the supplier was entitled to recover all these costs since the supplier would in normal circumstances have reasonably expected that the distributor would perform the contract to the best of its ability for the full three years, and not abandon it when it had barely started.²⁹⁵⁸

5. Contribution

The aggrieved party's contribution to its loss can be considered as another instance of the application of the causation requirement.²⁹⁵⁹ The aggrieved party may have failed to perform

²⁹⁵⁶ ICC (Final) Award in Case No. 7006, 1992, Yearbook Commercial Arbitration, (1993), at 59

²⁹⁵⁷ Ibid., at 64

²⁹⁵⁸ Ibid., at 63-64

²⁹⁵⁹ Similarly, it is argued that in international law, even though there does not appear to be full agreement over its characterization within the law of state responsibility, the concept of contributory fault fits within the discussion on 'causation' and in particular on 'concurrent causes', as a circumstance reducing the amount of

its specific or residual contractual obligations, or may have assumed explicitly or implicitly the risks of certain events relating to the period before the non-performance by the other party. The aggrieved party's failure to perform or the occurrence of such an event can become one of the causes that gave rise to its loss arising from the other party's non-performance. In determining the recoverable amount of damages, the decision maker applying *lex mercatoria* should take into account to what extent the aggrieved party's failure to perform such obligations, or the event, the risks of which it undertook, caused its loss allegedly arising from the non-performance of the other party, in order to accurately give effect to the reasonable expectations of the parties. The aggrieved party's failure to perform those obligations or the occurrence of the relevant event may be considered either as breaking the chain of causation between the non-performance and a particular loss, thereby leading to rejection of the claim for damages for such a loss, or as otherwise contributing to a particular loss, thereby requiring the decision maker to apportion that loss between the parties on the basis of the extent of their contribution.

In *MTD v. Chile*, the ICSID tribunal had to determine to what extent the claimant investors' unwise business decisions or lack of diligence caused its loss from a failed investment project of developing a satellite city in a Chilean municipality. In the case, despite the fact that the investment project was approved by the Chilean Foreign Investment Commission (FIC), the project did not comply with Chilean urban regulations and, thus, the investor eventually failed to secure a permit necessary to begin construction. The tribunal held that the approval of an investment by the FIC for a project that was against the urban policy of the Government was a breach of the obligation to treat an investor fairly and equitably. However, the tribunal considered that Chilean responsibility was limited to the consequences of its own actions to the extent they had breached the obligation to treat the claimants fairly and equitably, and it was not responsible for the consequences of unwise business decisions or for the lack of diligence of the investor.²⁹⁶⁰ The defendant state contended that the claimants decided to invest in Chile without conducting meaningful due diligence, and contrasted the practices of the claimants with those followed by diligent foreign investors, who "routinely seek contractual protections against losses arising from difficulties in obtaining governmental authorizations by incorporating related representations and warranties, covenants, conditions precedent or subsequent, or other protective provisions".²⁹⁶¹ The ICSID tribunal stated that "The BITs are not an insurance against business risk and the Tribunal considers that the Claimants should bear the consequences of their own actions as experienced businessmen. Their choice of partner, the acceptance of a land valuation based on future assumptions without protecting themselves contractually in case the assumptions would not materialize, including the issuance of the required development permits, are risks that the Claimants took irrespective of Chile's actions."²⁹⁶² The tribunal stated that "the Claimants... had made decisions that increased their risks in the transaction and for which they bear responsibility, regardless of the treatment given by Chile to the Claimants. They accepted to pay a price for the land with the Project without appropriate legal protection. A wise investor would not have paid full price up-front for land valued on the assumption of the realization of the Project; he would at least have staged future payments to project progress, including the issuance of the

compensation. Ripinsky, Sergey, & Kevin Williams, *Damages in International Investment Law*, London: British Institute of International and Comparative Law, 2008, at 314

²⁹⁶⁰ *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile* (ICSID Case No. ARB/01/7), Award rendered on May 25, 2004, at para. 166

²⁹⁶¹ *Ibid.*, at para. 169-170

²⁹⁶² *Ibid.*, at para. 178

required development permits.”²⁹⁶³ The tribunal held that the claimants should bear part of the damages suffered and estimated that share to be 50% of the damage they had suffered.²⁹⁶⁴

Thus, the tribunal identified a risk of the event that the investment project may not comply with local legal requirements for obtaining necessary approvals and permits, and allocated that risk to the claimants on the basis of the practices of diligent foreign investors. It can also be said that the tribunal derived a residual contractual obligation from those practices of foreign investors, which required the claimants to perform reasonable diligence in seeking out information to protect their own interests. The assumption of this risk or obligation by the claimants was also confirmed by the Foreign Investment Contract between FIC and the claimants, which provided that: “In any event, it is established that the Foreign Investor shall be subject to the current laws and regulations in effect regarding its activities. The present authorization is without prejudice to any others which, pursuant to such laws and regulations must be granted by the competent authorities.” The parties did not dispute the word “others” in this clause referred to other authorizations required by Chilean laws and regulations.²⁹⁶⁵ In this context, Chile also had an obligation to act coherently and apply its policies consistently, independently of how diligent an investor is.²⁹⁶⁶ The tribunal then took into account both parties’ respective failures as causes of the loss, in assessing the amount of damages recoverable by the claimants.

Chile filed an application requesting the annulment of the award. It argued that even if some apportionment of responsibility was appropriate, the Tribunal gave no reason for apportioning the loss on a 50:50 basis. In Chile’s view, the real and evident cause of the claimants’ loss was their failure to conduct adequate due diligence.²⁹⁶⁷ Thus, it requested the annulment of the award “[d]ue to the Tribunal’s failure to state its reasons upon which it diminished the Award by an arbitrary and unexplained fifty percent (and not 100 percent), as well as its manifest failure to apply any law that the Parties agreed to in the BIT (whether the Tribunal applied equity or other unidentified precepts to make its fifty percent reduction)”.²⁹⁶⁸ The ad hoc Committee agreed that some further reasons for a 50:50 split of damages could have been offered. However, the Committee rejected to consider it as a ground for annulment. Although the tribunal, in apportioning the loss, did not refer to any related doctrines under international law, and did not even use the terms, such as contributory fault or negligence, the Committee referred to Article 39 of the ILC’s Articles on Responsibility of States for Internationally Wrongful Acts of 2001, which contained the provision titled “Contribution to the injury”.²⁹⁶⁹

²⁹⁶³ Ibid., at para. 242

²⁹⁶⁴ Ibid., at para. 243

²⁹⁶⁵ MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile (ICSID Case No. ARB/01/7), Decision on the Application for Annulment issued on March 21, 2007, at para. 14

²⁹⁶⁶ MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile (ICSID Case No. ARB/01/7), Award rendered on May 25, 2004, at para. 165

²⁹⁶⁷ MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile (ICSID Case No. ARB/01/7), Decision on the Application for Annulment issued on March 21, 2007, at para. 39

²⁹⁶⁸ Ibid., at para. 98

²⁹⁶⁹ “Contribution to the injury: In the determination of reparation, account shall be taken of the contribution to the injury by wilful or negligent action or omission of the injured State or any person or entity in relation to whom reparation is sought.” Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001, Text adopted by the International Law Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission’s report covering the work of that session (A/56/10), at 109

The Committee considered that since the ILC's Articles included claims brought on behalf of individuals, there is no reason not to apply the same principle of contribution to claims for breach of treaty brought by individuals.²⁹⁷⁰ It stated that "the Tribunal had already analysed the faults on both sides in some detail, holding both to be material and significant in the circumstances. As is often the case with situations of comparative fault, the role of the two parties contributing to the loss was very different and only with difficulty commensurable, and the Tribunal had a corresponding margin of estimation. Furthermore, in an investment treaty claim where contribution is relevant, the respondent's breach will normally be regulatory in character, whereas the claimant's conduct will be different, a failure to safeguard its own interests rather than a breach of any duty owed to the host State. In such circumstances, it is not unusual for the loss to be shared equally. International tribunals which have reached this point have often not given any "exact explanation" of the calculations involved. In the event, the Tribunal having analysed at some length the failings of the two parties, there was little more to be said – and no annulable error in not saying it."²⁹⁷¹

The approach under *lex mercatoria* to the issue of causation contrasts with the general solutions of some legal systems, with regard to the requirement of causality, which generally assume either that the party in breach is fully liable, or that he is not liable at all, and largely neglect or avoid the possibility of awarding damages to a reduced extent. On the other hand, other national legal systems, which have introduced a specific rule to apportion liability for breach of contract, such as contributory negligence, distinguish the issue of contribution from that of causation.²⁹⁷² In ICC Case No 11440, the parties entered into a Master Agreement by which the defendant sold its business to the claimant. The parties agreed that the agreement was to be governed by German substantive law without reference to other laws, and excluded the application of the CISG. The buyer alleged that the seller violated representations, warranties and other obligations and initiated ICC arbitration, claiming compensation from the seller. The buyer argued that it was entitled to compensation from the seller for the costs it had to pay for the renewal of non-transferable software licences (the Licences). In the view of the buyer, the Licences were assets and should be transferred as part of the business. According to the buyer, by not including them on the list of Licences specified in the agreement, the seller did not disclose their non-transferability and had violated its specific duty of information. The seller argued that the Licences could not be qualified as assets, and that the buyer was aware of the non-transferability of the Licences.²⁹⁷³

The arbitral tribunal noted that the agreement provided that a list should be supplied of licences for intellectual property rights which would not be able to be used by buyer. The tribunal held that the seller did not provide such a list, implying that there were no licences of that category and, thus, violated its duty of information. Moreover, the tribunal stated that "As usual in M&A transactions the duty of disclosure and of correct information is expressed several times and conceptualized as a guarantee." On the basis of the provisions of the contract and the concept of the agreement as a whole, the tribunal discussed the issue of transferability under the aspect of correct and complete information.²⁹⁷⁴ Given that the seller

²⁹⁷⁰ MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile (ICSID Case No. ARB/01/7), Decision on the Application for Annulment issued on March 21, 2007, at para. 99

²⁹⁷¹ *Ibid.*, at para. 101

²⁹⁷² Cafaggi, Fabrizio, *Creditor's Fault: In Search of a Comparative Frame*, EUI Working Papers Law No. 2009/15, available at <http://ssrn.com/abstract=1551825>, at 5

²⁹⁷³ ICC Award in Case No. 11440, 2003, *Yearbook Commercial Arbitration*, (2006), at 135

²⁹⁷⁴ *Ibid.*, at 136

did not provide the buyer with the correct and complete information regarding the Licences, although the problem of transferability was an issue in the discussions and remained unresolved in the negotiations, the tribunal considered that the violation of the duty of information was apparent.²⁹⁷⁵ The tribunal stated that “In principle, violations of information-duties are cured by a specific mechanism: The person that has the right to be correctly informed has to be put in the position it would have if it had received the correct information in time. Thus, if damage results from the incorrect or incomplete information that damage must be compensated. The [agreement] provides a different solution that stems from the practice of M&A contracts. In these contracts, information-duties are conceptualized as guarantees. Consequently, they have been included in the [agreement]... in the category of ‘Representations and Warranties.’ It follows that a breach of an information-duty which is understood as guarantee must have consequences that correspond to that legal qualification.” The tribunal considered that the buyer should be entitled to claim damages calculated on the hypothesis that the respective representation or warranty was considered true.²⁹⁷⁶

As to the argument of the seller that the buyer’s claim must be reduced due to contributory negligence, the tribunal stated that “With regard to the technique of an M&A transaction and to its typical mechanism of representation and warranties it may generally be true that there is no room for the application of a contributory negligence rules as Sect. 254 BGB. However, in the case at hand the parties have explicitly agreed upon the applicability of Sect. 254 BGB... Therefore the Arbitral tribunal has to take into consideration any contributory negligence of the buyer.”²⁹⁷⁷ The tribunal considered that it is a generally accepted principle of contract law that the parties already have mutual obligations in their pre-contractual relationship, which include the duty of fair dealing and avoiding damages for both future partners. According to the tribunal, the buyer violated this duty by its negligence with regard to the advice of the buyer’s witness that the Licences were an open issue and that nothing was filed in the due diligence data room, since if that advice had been followed up, the damage caused could have partially been avoided, e.g. by reduction of the purchase price. The tribunal took into account this negligence on the basis of Section 254 of the German Civil Code and assessed the contributory negligence of claimant as one third of the amount claimed by the buyer for the costs of the renewal of the Licences.²⁹⁷⁸

However, despite the existence of the rule of contributory negligence in the applicable German law, the tribunal apparently based its reasoning on a contextual approach of causation as a matter of risk allocation between the parties in the particular case. The tribunal considered at an abstract level that, in the practice of M&A transactions, the risk of events not disclosed by the seller during the due diligence investigation of the buyer is allocated to the seller, and the materialization of that risk would entitle the buyer to claim damages for its entire loss caused by the seller’s non-disclosure. The tribunal also took into account a clause in the agreement, which provided that “Sect. 254 BGB shall apply to all claims under indemnities, representations and warranties.” On the basis of this clause, the tribunal considered that the risk of events not disclosed by the seller was shared between the seller and the buyer. According to this risk allocation, the seller was obliged to disclose certain information, while the buyer was obliged to exercise diligence in seeking out such

²⁹⁷⁵ Ibid., at 137

²⁹⁷⁶ Ibid., at 138

²⁹⁷⁷ Ibid., at 139

²⁹⁷⁸ Ibid., at 140

information and raise problematic issues for further discussions during the negotiations and in the determination of the purchase price. The tribunal eventually declined to award the share of the loss that was caused by the buyer's failure to comply with this residual obligation that arose from the agreement.

Essentially, the law of causation directs the decision maker, first, to decide, as a matter of law, what causal connection the law requires and, then, to decide, as a question of fact, whether the party claiming the causal connection has satisfied the requirements of the law.²⁹⁷⁹ Where the decision maker is granted sufficient flexibility to look beyond the formal consolidations of the legal systems through the interpretation of the contract and its supplementation with individualized terms, he may decide the first question, by focusing on the law between the parties to a particular contract and seeking causal connections between the alleged loss and the specific and residual contractual rights, obligations and risk allocations, and the second question, on the basis of estimates and approximations in the particular circumstances of the case, as long as the causal connection is reasonably certain, in accordance with the established limitation of certainty of damages.

The issue of the contribution of the aggrieved party to the harm or loss it has suffered as a result of non-performance will usually be brought before the decision maker through the counterclaims of the defendant. In ICC Case No. 5835, the claimant, the sub-contractor, sought damages and release of performance bonds under a contract for the supply, installation and maintenance of electrical works. It argued that, despite completion of work by the claimant, the defendant, the main contractor, wrongfully withheld sums due and refused to release performance bonds. The defendant counterclaimed damages arising from the delayed completion of work, alleging that such delay was due to several failures to perform by the claimant. The arbitral tribunal decided to apply Kuwaiti law and, to the extent necessary, principles generally applicable in international commerce.²⁹⁸⁰ In an interim award, the arbitral tribunal had decided that the claimant was responsible for the delay of the project and shall be liable, in principle, for the damages suffered by the defendant. The tribunal reserved the determination of the extent of the claimant's liability and the amount of damages to the final award. For that purpose, the tribunal asked the expert, *inter alia*, to determine the extent of the delay for which the claimant is responsible, taking into account all relevant circumstances, including other sub-contractors' delays and the defendant's conduct.²⁹⁸¹

The expert proceeded to determine the allocation of the responsibility for delay on the basis of two different global approaches due to the lack of adequate evidence supporting a detailed allocation of delay to one or the other party. In a first global approach, the expert listed the main causes of the delay, which were suggested by the parties, and found by the expert, and allocated certain percentages of weight to them. In a second global approach, the expert based his assessment of the development of the works mainly on the monthly payment certificates, and found that that "twelve months of the total 44 months was [the defendant]'s own responsibility whereas Claimant bears the responsibility for a total of 32 months (72%)". The tribunal considered Article 300 (1) of the Kuwaiti Civil Law, and stated that "The wording of Article 300 Sect. 1 ("Compensation shall be estimated by the court . . .") indicates that apart from the debtor's failure other factors which may have contributed to the extent of the

²⁹⁷⁹ Hoffmann, Leonard, Causation, *Law Quarterly Review*, 121 (October 2005), at 603

²⁹⁸⁰ ICC Final Award in Case No. 5835, 1996, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 35

²⁹⁸¹ *Ibid.*, at 37

damages, will have to be taken into consideration when the quantity of damage claims is to be assessed. This is particularly true with respect to the creditor's conduct as a contributing factor.” According to the tribunal, this generally accepted principle was summarized by Article 7.4.7 of the UNIDROIT Principles. Applying these principles and considering the conduct of each of the parties as described in the interim award and in the expert's report, the tribunal concluded that the amount of damages to be awarded to the defendant should be reduced by one quarter.²⁹⁸²

In order to give effect to the reasonable expectations of the parties, the decision maker applying *lex mercatoria* should not be precluded from considering the contribution of the aggrieved party to its loss as an issue of causation and from exercising its discretionary power in relation to the assessment of the amount of recoverable damages, by the strict position of the national legal systems as to the doctrine of contributory negligence. In ICC Case No. 9594, the arbitrator considered the extent of contribution of both parties to the harm suffered by the aggrieved party, under the applicable English law. In the case, the claimant, a Spanish company, agreed to manufacture and install industrial machinery for the defendant, a company based in India. Following the installation of the equipment, various technical problems arose, which led the defendant to withhold the final part of its payment, despite the claimant's efforts to solve the defects and overcome their differences. The claimant initiated arbitration proceedings, claiming damages for the defendant's breach of its contractual obligations. The defendant responded with a counterclaim in which it accused the claimant of various breaches of contract concerning, amongst other things, equipment defects and delayed performance. The defendant also claimed consequential damages, since the defendant began to use the machinery thereby manufacturing defective goods which gave rise to claims for damages by its customers. The arbitrator referred to the general principle concerning damages under English contract law that the party who suffered the damages should be put in the same position as it would have been if the contract had been performed. The arbitrator noted that there are two limitations to this principle: “(1) the degree of likelihood, namely, the types of damage which a contract breaker shall be responsible for and (2) mitigation of the loss, a duty of the party who suffered the damages to limit or altogether avoid the consequences of the breach.”²⁹⁸³

With regard to the first limitation, the arbitrator, referring to the case *Hadley v. Baxendale*, stated that it may be presumed that when the claimant entered into the agreement, it knew that the defendant wanted to purchase the machinery to produce parts for their consequent sale to the relevant industry, that the delay in the planning scheduled could cause the defendant to suffer damages, and that, if the machinery did not comply with quality requirements, it would have consequences in its productivity. The arbitrator considered that the claimant could have foreseen that if it did not conclude the whole commissioning process of the machinery within a reasonable time and that if the machinery did not comply with quality requirements, the defendant would suffer significant loss. According to the arbitrator, the question was whether the claimant could have foreseen that its delay would cause the large amount of loss claimed by the defendant. In this regard, the arbitrator noted that, both parties were responsible for delays and quality damages to the machinery. The arbitrator concluded that, “While [Claimant] should be held responsible for specific items where it is contractually liable and compensation is awarded to [Defendant], it is difficult, if not impossible, to assign

²⁹⁸² Ibid.

²⁹⁸³ ICC Award in Case No. 9594, March 1999, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 73

responsibility for consequential damages when both parties share in that responsibility. Furthermore, it is necessary to take into account [Defendant]'s obligation to mitigate the losses”.²⁹⁸⁴

As to the principle of mitigation of loss, the arbitrator not only referred to the leading English cases stating the duty of mitigation, but also stated that “a similar standard has been established internationally, primarily in the UNIDROIT Principles.”²⁹⁸⁵ The defendant argued that it acted to mitigate its loss by accepting the machinery since, should it have rejected the machinery it would have certainly incurred much greater losses. However, the arbitrator, referring to a relevant English case, was of the opinion that the defendant should have considered the options of mitigating its loss through negotiation and accommodation, and should have accepted the offers made by the claimant after the commissioning to sign a provisional acceptance of the line. Moreover, even if it was supposed that the defendant could have deemed this offer unacceptable, the arbitrator took into account that the defendant continued using the machinery to produce a large amount of parts, in spite of its alleged collapsing state, without taking serious measures to repair the defects in the machinery in a timely manner. According to the arbitrator, the defendant had ample opportunity to mitigate its losses, but it only took reasonable steps to do so once these arbitration proceedings were filed. The arbitrator rejected the recovery of losses due to the claimant’s alleged breach of quality, on the ground that the losses could have been mitigated by the defendant through either further negotiation (by accepting the claimant’s offer) or by having taken the timely steps required to repair the machinery.²⁹⁸⁶

Although it is not perfectly clear from the published excerpts, it can be said that the arbitrator took into account both the defendant’s contributions to its loss, where the defendant caused some of the delays and quality damages to the machinery, and the defendant’s failure to take all reasonable steps to mitigate the loss, and those causes culminated in the arbitrator’s decision to reject the defendant’s claim for damages for the consequential loss arising from the claimant’s breaches. In essence, in English law, there is some support for apportioning the loss by taking account of the aggrieved party’s contribution to its loss as a matter of causation.²⁹⁸⁷

c. Contractual Limitations to the Amount of Damages

The contractual limitations to the amount of damages for non-performance are such mechanisms that aim at restricting the scope of judicial discretion in relation to the assessment of damages for non-performance. The limitation or exemption of liability clauses can be considered as the main examples of such mechanisms. However, in cases where the contract contains a limitation or exemption of liability, the first issue that needs to be determined by the decision maker is the common intention of the parties as to the scope of such a clause and whether it is applicable in the particular circumstances of the case. In ICC Case No. 8362, the manufacturer unlawfully terminated its exclusive distributorship agreement with the claimant and assigned the claimant’s rights under the agreement to a third party. The claimant sought damages for its lost profits. The agreement contained a limitation of liability clause, which

²⁹⁸⁴ Ibid., at 74

²⁹⁸⁵ Ibid., at 75

²⁹⁸⁶ Ibid., at 76

²⁹⁸⁷ *Tennant Radiant Heat Ltd v Warrington Development Corporation* [1988] 1 E.G.L.R. 41

provided that, in the event of any breach of the manufacturer's warranty with regard to the product, the manufacturer shall not be liable for any special, indirect, punitive, exemplary or consequential damages, whether foreseeable or not, including but not limited to lost profits from any cause whatsoever. The defendant argued that, under the applicable New York law, mere placement of a provision containing a waiver of consequential damages within a clause addressing the seller's liability for product use does not limit the general effect of the waiver, and the language "from any cause whatsoever" in the relevant clause was intended as a general blanket exclusion of recovery of lost profits.²⁹⁸⁸ The claimant contended that the proper construction of the relevant clause required that it be considered in the context in which it appeared, and the context clearly showed that it was intended to be an exclusion of certain types of damages arising out of breach of product warranties. According to the claimant, its argument was supported by the fact that the types of damages excluded were those that are generally relevant to a tort or breach of warranty action.²⁹⁸⁹

The arbitrator considered that the context of the limitation of liability clause clearly indicated that it was intended to apply to product and trademark warranties alone. According to the arbitrator, the limitation of liability clause was clearly limited to damages other than direct or general damages, and its lost profits exclusion was clearly restricted to lost profits within the categories of damages enumerated. The arbitrator noted that the conveyance by the defendant of the claimant's rights to a third party in breach of the distributor agreement deprived the claimant of the essence of what it bargained for: the exclusive right to resell the products in a defined territory at a profit. Thus, the arbitrator stated that the damages incurred by the claimant were direct or general damages. The arbitrator was of the opinion that the plain intent of the disclaimer of liability for lost profits under the relevant clause was to exclude lost profits caused by the breach of warranty that are in the nature of special, indirect, punitive, exemplary or consequential damages. As the damages claimed by the claimant were direct damages, the arbitrator held that the limitation of liability clause did not apply.²⁹⁹⁰

A contract term providing that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance may also have the effect of limiting the amount of recoverable damages. However, given that the functions of penalty or contractual assessment of damages are generally perceived in the doctrine as the primary function of such clauses, the focus have been put on the issue of excessive penalty clauses and their treatment under the general principles of law. It is argued that it should be possible for the arbitrators to apply a principle, based on comparative law, whereby the effects of excessive penalty clauses should be tempered, which is also in accordance with the approach of international restatements of contract principles, since, in this view, reducing the effects of penalty clauses, rather than holding such clauses void altogether, would be more in keeping with the spirit of international commercial law, particularly in cases where the parties have submitted their disputes to general principles of law or remained silent as to the applicable law.²⁹⁹¹

There is a fundamental difference in this regard between the approaches of common law and civil law systems. Under common law, the court, which finds that an agreed damages clause

²⁹⁸⁸ ICC Award in Case No. 8362, 1995, *Yearbook Commercial Arbitration*, 22 (1997), at 173

²⁹⁸⁹ *Ibid.*, at 174

²⁹⁹⁰ *Ibid.*, at 175

²⁹⁹¹ Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 833

is a penalty clause, does not reduce the amount that can be recovered under the clause, but relegates the aggrieved party to its claim at common law for damages where the aggrieved party must prove the loss which it has suffered as a result of the breach. In contrast, under civil law systems, the courts may reduce a contractually specified sum under certain conditions, but it is not required to award damages limited to the aggrieved party's actual loss, and may impose more than the amount of actual damages in order to preserve the clause's punishment function. In view of this fundamental difference, the approach of civil law systems cannot be considered as the established rule in the order of international commerce. The decision maker will have to seek the established rule in the particular case by applying *lex mercatoria* at the stage of conflict of laws and in the public policy considerations. Only where the parties chose *lex mercatoria* to govern the substance of the dispute to the exclusion of any particular national law, the decision maker will assume, to some extent, the control of the resulting legal uncertainty and seek an appropriate solution in the particular circumstances of the case. In order to give effect to the reasonable expectations of the parties in accordance with the public policy considerations, the decision maker may prefer either to refer to the international restatements, which adopt the civilian approach, to assist his abstract reasoning, or to resort to the common law approach if the dispute is particularly connected to the common law jurisdictions.

This fundamental difference between civil and common law approaches may lose its importance, in the circumstances of a particular case, where the clause's function of limiting the amount of recoverable damages for non-performance prevails over its function as punishment for non-performance, and the relevant clause becomes a contractual limitation to the scope of judicial discretion in relation to the assessment of amount of damages for non-performance. In ICC Case No 4629, the parties' intentions indicated that the limitation function of the liquidated damages clause in the particular circumstances of the case militated against its traditional conception as a penalty under the applicable civil law system. The dispute concerned a construction contract, whereby the claimants undertook an obligation to finish and furnish the defendant's hotel. The claimants were found to be entitled to terminate the contract and to claim liquidated damages under the contract. The contract provided that the liquidated damages must be computed as "10% of the sums paid or due in accordance with this contract if the defaulting party is the owner." The contract also provided that if termination occurs for any reason, the claimants were entitled to be paid for the work effectively done.²⁹⁹²

The tribunal stated that the understanding that the liquidated damages would have increased in proportion to the degree of completion of the work would not make sense, since the contractor would not have been entitled to any liquidated damages if the contract had been terminated before the beginning of the work, while the contractor would have been entitled to claim almost the full amount of the liquidated damages if the termination had occurred at the time when the work was almost finished, when his real damages were much less than in the first case. Thus, the tribunal considered that the phrase "sums paid or due" cannot refer to anything else but to the total price of the contract, regardless of the state of completion of the contract at the time of termination. After having examined the possibility of reducing contractually agreed liquidated damages under the applicable Swiss law, the tribunal decided not to modify them. The tribunal stated that "the parties are in better position than the judge to estimate the amount of the liquidated damages applicable to their relations." The tribunal also considered reduction as an exceptional remedy, which must be applied only when the liquidated damages

²⁹⁹² ICC Award in Case No. 4629, 1989, Yearbook Commercial Arbitration, (1993), at 17

are so high that they exceed any common measure and are therefore incompatible with the idea of justice and equity. Having considered the various circumstances relevant in the case law, such as disproportion between the real damages and liquidated damage, gravity of the defendant's default, financial situation of the parties, the tribunal decided not to reduce the liquidated damages.²⁹⁹³

Given that, in addition to liquidated damages, the defendant had to pay the unpaid part of the price due for the work already performed at the time of the termination, the tribunal discussed whether the total price must be reduced for the failures of the claimants to fulfill their contractual obligations. On the basis of the expert evidence, the tribunal first determined that the proportion of the work that was achieved at the time of termination was 77.05% of the total work.²⁹⁹⁴ The tribunal then investigated whether the amount must be further reduced due to some defaults or criticism made by the expert regarding the quality of some of the materials used by the claimants. The tribunal noted that the expert report stated a few minor defects in the construction, and considered it highly probable that part of the defects noted by the expert were due to the claimant's fault. The tribunal found it difficult, on the sole basis of the expert report, to determine the exact amount of the reduction to be made. Thus, the tribunal reduced the total price on the basis of its discretion by applying Article 42 (2) of the Swiss Code of Obligations, which provides that damages which cannot be established in amounts shall be assessed by the judge in his discretion, having regard to the ordinary course of events and the measures taken by the damaged party.²⁹⁹⁵

Finally, the arbitral tribunal rejected the claimant's request for damages for all other losses and damages caused by the defendant's delay or failure to perform the contractual obligations. The tribunal noted that the contract was a lump sum contract, in which the price had been contractually fixed, and the price can be increased only if extraordinary circumstances, which could not have been foreseen, impede the completion or render it exceedingly difficult, pursuant to the Swiss Code of Obligations. The losses claimed by the claimants were additional costs related to the prolongation of the employment of their workers, extension of insurances and guarantee. The tribunal stated that these circumstances could have foreseen by the claimants, since they had started to work on the site before the effective date, i.e. at a date when they had no guarantee that the owner would live up with his contractual obligation, and the claimants were already indemnified for the damages occurred due to the defendant's defaults by substantial liquidated damages.²⁹⁹⁶ Thus, while the liquidated damages clause, to some extent, restricted the tribunal's scope of judicial discretion and limited the amount of damages recoverable by the contractor, the tribunal was still able to exercise its discretionary power, and even took into account the contractor's contribution as a result of its failure to perform its obligations, in determining the final amount of compensation through the reduction of the contract price, which the contractor was entitled to claim, in addition to the liquidated damages, to the extent of the work performed by the time of the termination.

In ICC Case No. 13278, the sole arbitrator considered a penalty clause as a liquidated damages as well as a limitation of liability clause under the applicable Spanish law in the particular circumstances of the case. The dispute arose from a sponsorship agreement between

²⁹⁹³ Ibid., at 24

²⁹⁹⁴ Ibid., at 25

²⁹⁹⁵ Ibid., at 26

²⁹⁹⁶ Ibid., at 31

the agent of a professional motorbike racer and a corporation, which was concluded for two seasons. The penalty clause provided that, in the case of termination by either party after the first season, the terminating party would have to fulfill its financial obligations by paying the salary of the biker for the second season. The biker terminated the agreement at the end of the first season and entered into another agreement with a third party for the second season. The corporation initiated arbitration proceedings, seeking payment of contractual penalty as well as damages. The arbitrator held that the defendant prematurely terminated the agreement, which provided for two years of cooperation.²⁹⁹⁷ The defendant argued that the general principles of Spanish Civil Code relating to the interpretation of contract did not govern the interpretation of penalty clauses, pursuant to the Spanish Supreme Court, which developed specific principles in this regard. The arbitrator did not accept this argument and decided to interpret the agreement in accordance with the general principles of interpretation under the Spanish Civil Code, bearing in mind the holding of Spanish Supreme Court that to the extent there is a doubt as to the existence or scope of the penalty clauses in the agreement, such clause is to be interpreted restrictively.²⁹⁹⁸ The arbitrator considered that the mere insertion of a penalty clause corroborated the interpretation of the agreement as a two-season commitment, since the penalty clause acted as a deterrent to end their relationship unreservedly at the end of the first season, in accordance with “the main function of a penalty clause under Spanish law”, which is “to guarantee the fulfillment of the obligation secured by the penalty”.²⁹⁹⁹ Thus, the arbitrator held that there was no doubt as to the existence or scope of the penalty clause in the agreement and there was no ground for restrictive interpretation.³⁰⁰⁰

The defendant requested the arbitrator to reduce the penalty. According to Article 1154 of the Spanish Civil Code, the court shall equitably modify the penalty when the principal obligation has been partly or irregularly performed. Thus, in the event of partial or irregular performance of the obligation the penalty clause intended to secure, the provision leaves no discretion to the court and mandates reduction. The arbitrator dismissed this request since, in her opinion, there was not partial or irregular performance but rather a total lack of performance, considering that the defendant terminated the agreement at the end of the first season, which was precisely the action the penalty clause sought to deter.³⁰⁰¹ The claimant argued that the defendant was further liable to pay damages on the ground that the penalty cannot be construed as a limitation of liability. The defendant argued that under Spanish law a penalty clause bars a creditor from claiming damages in addition to the penalty clause, subject to the parties agreeing to the contrary.³⁰⁰² The arbitrator considered that “under Spanish law, the predominant function of a penalty clause is to liquidate damages beforehand and to replace the payment of damages accordingly, it being specified that a contrary agreement is admissible if it is unequivocal.”³⁰⁰³ The arbitrator considered that there was no contrary agreement allowing the parties to claim damages beyond the amount of the penalty, and held that the penalty clause under the agreement was intended to deal fully with all the financial

²⁹⁹⁷ ICC Award in Case No. 13278, Yearbook Commercial Arbitration, (2008), at 131

²⁹⁹⁸ Ibid., at 126

²⁹⁹⁹ Ibid., at 132-133

³⁰⁰⁰ Ibid., at 133

³⁰⁰¹ Ibid., at 145

³⁰⁰² Ibid., at 146

³⁰⁰³ Ibid., at 147

consequences of the termination of the agreement for the second season.³⁰⁰⁴ Thus, although admitting that the “main function” of a penalty clause under the applicable Spanish law was to guarantee the fulfillment of the obligations, the arbitrator gave more weight to its function of limiting the amount of recoverable damages in the particular circumstances of the case, by considering that, under Spanish law, the “predominant function” of a penalty clause is to liquidate damages beforehand in the absence of contrary agreement.

In the application of such clauses that limit the non-performing party’s liability for damages in the event of non-performance, the decision maker applying *lex mercatoria* will also take into account the limits of binding effect of the contract, which is freely entered into by the parties, under the relevant public policy considerations. In ICC Case No. 13278, the arbitrator also considered the factors that may invalidate the limitation function of the penalty clause. The claimant argued that the biker breached the agreement willfully and deliberately and, also, continued giving assurances until the very last minute that he would fulfill his contractual commitments for the second season, thereby putting the claimant in a position that prevented it from procuring the services of another top biker. According to the claimant, the claimant acted with *dolo*, a concept under Spanish law roughly equivalent to bad faith that comprises the elements of willfulness and consciousness of the breach, but does not require a level of malicious intent. The claimant further argued that the defendant demonstrated not only *dolo* but also actual bad faith, since he confirmed to the claimant his intent to honor his commitment for the second season, while he had no intention of doing so, and, then he waited too long to communicate his intention to terminate. The claimant submitted that the defendant’s *dolo* and bad faith pursuant to the Spanish Civil Code, entitled the claimant to all of its damages suffered as a result of the defendant’s breach.³⁰⁰⁵

It was not disputed that the requirement of willfulness for *dolo* was met in the case, since it was the defendant’s deliberate decision to end the agreement. Therefore, the arbitrator examined whether the second requirement of consciousness was met. On the basis of the record, the arbitrator found that the parties discussed the future of the defendant and the defendant leaving the team, despite his two-year commitment, which the claimant repeatedly stressed during the meetings, but it remained unsettled whether the defendant would stay or not, and the defendant expressed its discontent with the team and never said he would stay unreservedly.³⁰⁰⁶ Regarding the claimant’s argument that the defendant’s decision to leave was untimely, the arbitrator noted that the decision not to renew for the second season belonged to both parties under the penalty clause of the agreement. The arbitrator considered that the circumstances led the defendant to believe that the claimant would undoubtedly replace him and the defendant could not have inferred that his leaving the team would cause any damage to the claimant.³⁰⁰⁷ Thus, the arbitrator did not consider that the defendant gave assurances that he would stay until the very last minute. Moreover, the arbitrator did not deem the defendant conscious that his leaving at the end of the first season would cause damage to the claimant under the circumstances. Accordingly, the arbitrator held that the defendant was fully aware that the financial consequences of his leaving at the end of the first season would be the payment of his salary for the second season as penalty, and it was not shown that the defendant was aware that his leaving would cause any damage beyond the penalty amount. As

³⁰⁰⁴ *Ibid.*, at 149-150

³⁰⁰⁵ *Ibid.*, at 150-151

³⁰⁰⁶ *Ibid.*, at 153-154

³⁰⁰⁷ *Ibid.*, at 154

a result, the tribunal decided that the second requirement of consciousness for *dolo*, which would give rise to damages in addition to the penalty, was not met and, thus, damages could not be claimed under Spanish law.³⁰⁰⁸

The fraud or willful breach on the part of the party in breach will usually invalidate the clauses limiting or excluding liability, as this will be the most common solution that can be found under the relevant national legal systems in this regard. However, the effect of gross negligence of the party in breach on the validity of clauses that limit the recoverable amount of damages require a more refined approach to the facts of the particular case, the purpose and nature of the contract as well as the mandatory rules of the relevant national legal systems.

In ICC Case No. 5835, the tribunal was of the opinion that it is an established rule in the order of international commerce that the gross negligence of the non-performing party invalidates the clauses that limit the amount of damages recoverable by the aggrieved party. The case concerned a construction contract between the claimant, the sub-contractor, and the defendant, the main contractor for the supply, installation and maintenance of electrical works. The contract was governed by Kuwaiti law and, to the extent necessary, by the principles generally applicable in international commerce. The defendant claimed damages arising from the delayed completion of work by the claimant. The claimant argued that the damages to be awarded to the defendant for the claimant's delay had already been assessed by the parties in the contractual penalty clause. The claimant submitted that the defendant should not be awarded damages in excess of stipulated amount for the reason that the claimant did not commit "fraud or grave mistake", by referring to Article 304 of the Kuwaiti Civil Law.³⁰⁰⁹

The arbitral tribunal found that the delay of the claimant was the result of its gross mistake, i.e. gross negligence. The tribunal explained the gross mistake as a conduct, which "grossly violates a fundamental rule of the art or if he repeatedly or continuously fails to perform in a timely manner important parts of his obligations." According to the tribunal, the intent to harm the contractual party does not constitute a prerequisite of a culpa grave claim for contractual negligence. The tribunal stated that "a party's conduct is grossly negligent if it shows an elementary failure of attention for the consequences of one's action and if it leads to a performance substantially different from what the other party reasonably expected." In this regard, referring to Article 7.1.6 of the UNIDROIT Principles, the tribunal stated that "'Gross mistake' under Kuwaiti law is not different from this generally accepted definition" and "had a narrower definition of 'gross mistake' been established under Kuwaiti law, the Tribunal would have had to follow 'principles generally applicable in international commerce'". The tribunal noted that the claimant's failures were extremely numerous and related to many important activities and the delay reached the extremely disproportionate period of 44 months. The tribunal concluded that the claimant's failures in the timely performance of the Agreement amounted to "grave mistake" in the sense of Article 304 of the Kuwaiti Civil Law and rejected the claimant's defense relating to the penalty clause.³⁰¹⁰

Although the tribunal's conclusion is justified in the case on the basis of the facts and the applicable legal rules, its consideration of Article 7.1.6 of the UNIDROIT Principles as the established rule in order of international commerce seems both questionable and, thus,

³⁰⁰⁸ Ibid., at 155

³⁰⁰⁹ ICC Final Award in Case No. 5835, 1996, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 36

³⁰¹⁰ Ibid., at 37

unnecessary. Essentially, the decisive finding for the invalidity of the penalty clause in limiting the amount of recoverable damages in the case was that the requirement of “gross mistake” under Kuwaiti law, which was closely connected to the contract, was met in the particular circumstances of the case. In the case, as noted by the tribunal, the relevant requirements of Kuwaiti law coincided with those of Article 7.1.6 of the UNIDROIT Principles.³⁰¹¹ However, as a product of abstract reasoning and specialized consolidations of its drafters, Article 7.1.6 of the UNIDROIT Principles was merely available to the tribunal in support of its finding and interpretation under Kuwaiti law, but might not have prevailed over the latter, as argued by the tribunal, if the latter had a narrower approach, given that the differences among the national legal systems in their approach to the effect of gross negligence of the party in breach on the validity of limitation of liability clauses preclude the identification of such substantive standards as “the principles generally applicable in international commerce”.

In ICC Case No 6320, which was actually cited by the tribunal in ICC Case No 5835, in support of its definition of gross negligence, the arbitral tribunal considered the effect of gross negligence on the validity of limitation of liability clauses, and found that neither the applicable law nor comparative law provided a clear answer in that regard. The tribunal concluded that the gross negligence was not an invalidating factor for such clauses in the particular circumstances of the case by referring to the risk allocation between the parties under their contract and a subsequent settlement protocol. In the case, the claimant, a utility company, and the defendant, a power plant equipment manufacturer, entered into a contract concerning the design, supply and other services relating to a power plant to be built in the claimant’s country. The contract provided for the application of Brazilian law. The completion of the project was delayed by a number of defects and problems. Many of them were subject to settlement in a protocol, which led to the claimant’s acceptance of the plant. A dispute arose between the parties in connection with their disagreement as to the scope and purpose of the contract and as to their contractual obligations. In the arbitration proceedings, the claimant sought to recover damages, both historical and future damages, related to the major components of the power plant, which, according to the claimant, had not specifically been settled in the protocol. The defendant asserted that there were a number of limitations in both the protocol and the contract, which operated to exclude entirely its alleged liability, or at least reduce it significantly.³⁰¹²

The arbitral tribunal noted that the protocol was drafted in far-reaching and comprehensive terms that reflected the intention of the parties to exclude all claims except those expressly admitted by the protocol itself. According to the tribunal, the language of the protocol indicated a general waiver, leaving only to determine which claims were covered by its terms and were thus not excluded. The tribunal held that there were only two categories of claims that were not excluded: claims with respect to defects occurring after the date of protocol, and claims, which were specifically set forth in the protocol.³⁰¹³ The protocol provided that any claim in the first category were to be handled strictly as per the terms of the contract’s warranties provision. The tribunal noted that none of the claimant’s claims fell under the

³⁰¹¹ The Official Comments to Article 7.1.6 of the UNIDROIT Principles explicitly provides that a party may not rely on a clause which limits or excludes its liability for non-performance, where the non-performance is the result of grossly negligent conduct. Official Comment 5 to Article 7.1.6 of the UNIDROIT Principles

³⁰¹² ICC Final Award in Case No. 6320, of 1992, *Yearbook Commercial Arbitration*, (1995), at 64-65

³⁰¹³ *Ibid.*, at 75

second category of the claims.³⁰¹⁴ The claimant argued that such prospective waivers in the protocol would not be admissible or recognized under the applicable law. The tribunal stated that the applicable law does not recognize prospective waivers of *dolo* (fraud) claims, and found this in conformity with “a generally recognized rule that claims based on fraud cannot validly be waived.” However, the tribunal noted that there are different opinions on the status of the applicable law with respect to *culpa grave* claim, which was defined by the tribunal as “a claim for contractual negligence not commonly found among men or gross negligence or elementary failure of attention or reckless disregard for the consequences of one’s actions.”³⁰¹⁵ The tribunal also considered that there is no clear conclusion from a comparative basis, considering that while United States and German law permit such waivers under certain conditions, French law does not. However, the tribunal stated that it did not have to decide whether a prohibition of such a waiver is compulsory under the applicable law, although the protocol must be interpreted as intending to apply also to *culpa grave* claims. The tribunal considered that, even if the applicable law prohibits such waivers, the claimant is estopped from invoking such a prohibition and, thereby, rescinding on “its part of the deal” under the protocol, having accepted the payments that the defendant made in fulfillment of its obligations under the protocol.³⁰¹⁶

Subsequently, the tribunal examined whether the defendant’s liability was limited by the contract, but only with regard to the claims that were not excluded by the protocol. The tribunal similarly considered that *dolo* claims were not excluded by the provisions of the contract because they are not waivable. As to the *culpa grave* claims, the tribunal stated that the principle of estoppel with regard to contractual waivers was even more applicable in view of the fact that the claimant accepted the comprehensive waiver in the various provisions together with the equally far-reaching “legal opinion provision” of the contract.³⁰¹⁷ The legal opinion provision required the claimant to provide to defendant legal opinions on the legality and validity of the contract under the applicable law, without the defendant having to request them. No such legal opinion had been provided. In these circumstances, the tribunal considered that the defendant could rely on the legality and validity of all contractual provisions under the applicable law. The tribunal concluded that the claimant was estopped from invoking the invalidity of any contractual provision, since it did not fulfill its obligation to furnish a legal opinion to the defendant as was its obligation under the contract.³⁰¹⁸ Thus, the tribunal held that, due to the findings concerning the limitations on the defendant’s liability from the protocol and the contract, all of the claimant’s possible claims were excluded, with the exception of *dolo* claims, and any warranty claims that would be within the warranty periods, as extended by the protocol.³⁰¹⁹

As to the *dolo* claims, the tribunal considered that burden of proving *dolo* was a heavy one: since fraud is a very serious accusation, it had to be satisfactorily proven.³⁰²⁰ However, the claimant did not satisfy its burden of proof, and the tribunal concluded that there was not

³⁰¹⁴ Ibid., at 76

³⁰¹⁵ Ibid., at 87

³⁰¹⁶ Ibid., at 77

³⁰¹⁷ Ibid., at 80

³⁰¹⁸ Ibid., at 81

³⁰¹⁹ Ibid., at 82

³⁰²⁰ Ibid., at 85

fraud in the performance of the contract.³⁰²¹ The claimant demanded compensation for losses it suffered in connection with the failure of the power plant's electric generator. The tribunal found that the failure of the electric generator occurred within the warranty period. However, the tribunal could not determine beyond all doubt whether the failure was caused only by the defects asserted by the claimant or only by other disturbances. Given the impossibility to attach in retrospect a precise percentage to either of these causes, the tribunal held that, on the basis of the evidence, each cause should be given equal weight, and, thus, defendant was liable to claimant for half of the otherwise compensable losses that resulted from the failure of the electric generator, which consisted of costs for repairs in connection with that failure.³⁰²² Thus, while the limitation or exemption of liability clauses can be considered as mechanisms restricting the scope of judicial discretion in relation to the assessment of damages for non-performance, the factual and contextual considerations of causality may enable the decision maker to exercise an abstract reasoning in relation to such matters that were not covered by those mechanisms, and ultimately determine the amount of recoverable damages.

d. Particularities of State Party Disputes

The basic precedent in relation to the application of the principle of full compensation in the context of state party contracts can be found in the case of Chorzow Factory from 1928. The issue in the case was Poland's expropriation of a nitrate factory owned by German nationals, in contravention to the provisions of the Convention concerning Upper Silesia concluded at Geneva on May 15th, 1922 (the Geneva Convention) between Germany and Poland. The Permanent Court of International Justice stated that "The essential principle contained in the actual notion of an illegal act - a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals - is that reparation must, as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed. Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award, if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it-such are the principles which should serve to determine the amount of compensation due for an act contrary to international law."³⁰²³ Many international tribunals have cited Chorzow Factory case as the paramount compensation principle to guide determinations of the appropriate measure of damages for the expropriation of investment.³⁰²⁴ However, the claims for compensation in cases involving expropriations or other breaches of contracts by the state party raise special problems for tribunals, since the state party's actions often not only injures the private party's business, but usually destroys it, and the tribunal must determine the value lost on the basis of projected future earnings that may be greatly affected by ever-changing and often unpredictable economic circumstances, such as interest rates and energy prices.³⁰²⁵

³⁰²¹ Ibid., at 86

³⁰²² Ibid., at 93

³⁰²³ Factory at Chorzów (Claim for Indemnity) (Merits) (F.R.G. v. Pol.), 1928 Permanent Court of International Justice, Series A, No. 13 (September 13, 1928), at 47

³⁰²⁴ E.g., *Metalclad Corp. v United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award of Aug. 30, 2000, *International Legal Materials*, 40 (2001), at 52; *Amco Asia Corp. v Indonesia*, Award of Nov. 21, 1984, *International Legal Materials*, 24 (1985), at 1037; *Iran-US Claims Tribunal, Amoco Int'l Finance Corp. v. Iran*, 15 IRAN-U.S. C.T.R., at 189, et seq., paras. 189-232

³⁰²⁵ Gotanda, John Y., *Damages in private international law*, *Receuil des Cours*, 326 (2007), at 173

In state party disputes, the compensation reflecting the capital value of property taken or destroyed is generally assessed on the basis of the “fair market value” of the investment, which will be calculated according to reasonable criteria, i.e. an amount that a willing buyer would normally pay to a willing seller after taking into account the nature of the investment, the circumstances in which it would operate in the future and its particular characteristics, including the period in which it has been in existence, the proportion of tangible assets in the total investment and other relevant factors pertinent to the specific circumstances of each case.³⁰²⁶ Since 1945, some valuation techniques for the reasonable determination of the market value of an investment have been developed to factor in different elements of risk and probability.³⁰²⁷ The discounted cash flow (DCF) method has gained some favor, especially in the context of a “going concern”, which means “an enterprise consisting of income-producing assets which has been in operation for a sufficient period of time to generate the data required for the calculation of future income and which could have been expected with reasonable certainty, if the taking had not occurred, to continue producing legitimate income over the course of its economic life in the general circumstances following the taking by the State”.³⁰²⁸

The DCF method determines the value of the business by projecting the net cash flow for a certain period of time into the future and then discounting it back to present value as of the date of the breach. It uses a discount rate that may include the components of currency fluctuations, inflation figures, commodity prices, interest rates and other commercial risks.³⁰²⁹ As an income based method to value the asset lost, in theory, the DCF fully compensates the claimant by awarding an amount that reflects both the loss incurred and gain of which it was deprived. Under the DCF method, the claimants ascertain a projected amount representing their future profits, often taking into account the remaining period of the contract or license, in addition to the alleged market value of the assets. In *Amco I Award*, P.T. Wisma, a company under the control of a cooperative established under Indonesian law for the welfare of active and retired Indonesian Army personnel, entered into a lease and management profit-sharing agreement with an American investor, Amco, which was to complete the construction of a hotel and undertake its management afterwards for a limited period of time. The hotel construction was completed substantially as planned, but P.T. Wisma persuaded the Indonesian government to revoke its investment license to Amco. The tribunal after laying down the principle that damages are to compensate the whole prejudice, whose two classical components are the loss suffered (*damnum emergens*) and the expected profits which are lost (*lucrum cessans*), stated that “the only prejudice to be taken into account for awarding damages is the loss of the right to operate the [hotel], that is to say the loss of a going concern. Now, while there are several methods of valuation of going concerns, the most appropriate

³⁰²⁶ The World Bank, *Guidelines on the Treatment of Foreign Direct Investment*, International Legal Materials, 31 (1992), at 1382; The Guidelines condemned the taking of private foreign property in the absence of public interest and appropriate compensation, which should be based, *inter alia*, on the fair market value of the property. The Guidelines are non-binding as the expert group felt that the time was not ripe for a binding multilateral code on investment. However, in the 1990s, a liberalization of the regime for foreign investment was generally favored with a proliferation of bilateral and regional treaties on investment, and the developing countries had for various reasons given up the attempt to create a New International Economic Order. Sornarajah, M., *The International Law on Foreign Investment*, Cambridge University Press; 3rd ed., 2010, at 237

³⁰²⁷ Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001, Text adopted by the International Law Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission’s report covering the work of that session (A/56/10), at 103

³⁰²⁸ The World Bank, *Guidelines on the Treatment of Foreign Direct Investment*, International Legal Materials, 31 (1992), at 1383

³⁰²⁹ Gotanda, John Y., *Damages in private international law*, *Receuil des Cours*, 326 (2007), at 173

one in the present case is to establish the net present value of the business, based on a reasonable projection of the foreseeable net cash flow during the period to be considered, said net cash flow being then discounted in order to take into account the assessment of the damages at the date of the prejudice, while in the normal course of events, the cash flow would have been spread on the whole period of operation of the business.... Accordingly, the net discounted cash flow value and the net present value will be calculated from April 1, 1980 to September 30, 1999 inclusive, this being the time limit of the profit sharing agreed upon by P.T. AMCO and P.T. Wisma.”³⁰³⁰

It is argued that the DCF method ascribes undue importance to *lucrum cessans* as a component of full compensation and, thus, it is resorted to by investors when they seek a substantial amount of compensation based on speculation, for which it would be difficult to find any legal rationale.³⁰³¹ However, the problems relating to awarding lost profits in the context of state party disputes are not specific to the use of the DCF method. Even if the arbitral tribunals do not resort to the DCF method, the calculation of the amount of damages in state party contracts may still appear as arbitrary or rendered without reason, where the investment was a new venture and, the investor had never earned any profits. In *MINE v. Republic of Guinea*, the dispute concerned the agreement for ocean transportation of bauxite and the establishment, for thirty years, of a mixed-economy company, called SOTRAMAR for exercising Guinea’s freight rights. MINE argued that Guinea breached the agreement when it secretly negotiated and subsequently contracted with AFROBULK, a third party, to use the freight rights. The tribunal held that Guinea prevented SOTRAMAR from performing under the agreement, and breached the agreement when Guinea entered into agreement with AFROBULK. MINE put forward various theories under which it was entitled to damages measured by the profits it lost on the basis of “the expectancy of MINE’s share of the net profits that SOTRAMAR would have earned if Guinea had performed the convention by letting SOTRAMAR go into operation.”³⁰³² However, the tribunal noted that SOTRAMAR never earned any profits, and considered that because it was a new venture, the projection of the expectancy of net profit was too speculative to use in assessing damages. Even so, the tribunal held that the lost profits need not be proven with complete certainty, nor should

³⁰³⁰ ICSID Award *Amco Asia Corp. et al. v. Republic of Indonesia*, International Legal Materials, 24 (1985), at 1037; The Republic of Indonesia applied for the annulment of the award, arguing that the tribunal, by finding that Amco’s investment shortfall was not material and did not justify the revocation of the investment license, had manifestly exceeded its powers, had seriously departed from a fundamental rule of procedure and had failed to state the reasons on which it based the award. The ad hoc Committee found that the tribunal in calculating Amco’s investment had manifestly exceeded its power in failing to apply fundamental provisions of Indonesian law and had failed to state reasons for its calculation. Thus, the ad hoc Committee annulled the part of the award relating to the illegality of the revocation order and granting Amco damages on this account. However, the tribunal’s finding as to the illegality of the action by army and police personnel and that Amco was entitled to damages therefore from Indonesia was not annulled. Ad hoc Committee Decision on the Application for Annulment of May 16, 1986, International Legal Materials, 25 (1986), at 1458-1463; The dispute was resubmitted to the ICSID. In the second award, which is examined in detail below, the second tribunal not only awarded damages for losses caused as a result of the illegal police and army intervention, but also held that the circumstances surrounding the decision revoking the license made it unlawful and that non-speculative profits under the management contract were recoverable. Final award of 5 June 1990 in case no. ARB/81/8 and Decision on Supplemental Decision and Rectification of 17 October 1990, Yearbook Commercial Arbitration, (1992), at 73 et seq.

³⁰³¹ Chatterjee, Charles, The Use of the Discounted Cash Flow Method in the Assessment of Compensation, Comments on the Recent World Bank Guidelines on the Treatment of Foreign Direct Investment, Journal of International Arbitration, 10 (1993), at 21

³⁰³² ICSID Award January 6, 1988, Maritime International Nominees Establishment (MINE) v. The republic of Guinea, Yearbook Commercial Arbitration, (1989), at 88

recovery be denied simply because the amount is difficult to ascertain.³⁰³³ The tribunal found that MINE's loss of profits could be measured adequately by the AFROBULK agreement, i.e. the amount per ton which AFROBULK received from Guinea for the right to carry bauxite during a two-year period rightfully belonged to SOTRAMAR. The tribunal stated that, "it seems fair to conclude that such an arrangement could have been extended, or negotiated with others, to a total period of 10 years." According to the tribunal, even if the agreement was to last 30 years, the ten-year period was reasonable, considering that the agreement contained provisions for early termination and the bauxite receivers were bound to Guinean bauxite for only 20 years.³⁰³⁴

The portion of the tribunal's award relating to damages was annulled by the ad hoc Committee established pursuant to Article 52 of the ICSID Convention for failure to state the reasons on which it is based. The Committee noted that pursuant to the agreement between the parties, all MINE would be entitled to if Guinea had breached that agreement was damages for one year. According to the Committee, the tribunal either failed to consider this contractual clause, or it did consider it but thought that Guinea's arguments should be rejected, but that did not free the tribunal from its duty to give reasons for its rejection as an indispensable component of the statement of reasons on which its conclusion was based.³⁰³⁵ Moreover, the Committee stated that MINE's "worst case" scenario and the damages calculation by the tribunal had in common that they did not purport to estimate profits that SOTRAMAR would have made, but rather took as a base either the actual or hypothesized profits under the substitute AFROBULK arrangements. The Committee stated that "The theory underlying this approach, which was not articulated either by the parties or by the Tribunal, may have been that for Guinea to keep the fruits of the substitute arrangements, which according to the Tribunal's ruling on breach of contract it had concluded in violation of the Agreement, would have constituted unjust enrichment, and that MINE should therefore be awarded the same share of those profits as it was entitled to receive if they had been SOTRAMAR profits."³⁰³⁶ However, the Committee noted that the tribunal assumed, without explanation and contrary to what really happened, that arrangements yielding the royalty rate of the AFROBULK agreement could have been concluded for a period of ten years. In the Committee's view, the tribunal contradicted itself by adopting "damages theory" which disregarded the real situation and relied on hypotheses as a basis for the calculation of damages, despite having concluded that theories of MINE with regard to the calculation of damages were unusable because of their speculative character.³⁰³⁷

In this context, the tribunals should generally adopt a cautious and reasoned approach to the calculation of lost profits in state party disputes. In the case of the DCF method, this approach is clearly necessitated by the absence of clear rules and the existence of many assumptions, estimates and other subjective elements for determining the two factors used in the DCF method: (i) projecting the company's earnings based on a wide variety of factors, including the company's past earnings history, its projected outlook, and the industry outlook, and (ii)

³⁰³³ Ibid., at 89

³⁰³⁴ Ibid., at 90

³⁰³⁵ Ad Hoc Committee, *Maritime International Nominees Establishment v. Republic of Guinea*, Decision partially annulling the award, December 22, 1989, ICSID Review—Foreign Investment Law Journal, 5 (1990), at 124

³⁰³⁶ Ibid., at 125

³⁰³⁷ Ibid.

setting the discount rate, that takes into account multiple variables, including the expected rate of inflation, the real rate of return, and the riskiness of the income stream.³⁰³⁸ Thus, it is argued that, although income-based methods have been accepted in principle, there has been a decided preference for asset-based methods.³⁰³⁹ An asset-based valuation method for investments focuses on the determination of net book value, i.e. the difference between the total assets of the business and total liabilities as shown on its books.³⁰⁴⁰ Its advantages are that the figures can be determined by reference to market costs, they are normally drawn from a contemporaneous record, and they are based on data generated for some other purpose than supporting the claim for damages.³⁰⁴¹ However, the book value method has also been criticized as not accurately reflecting the value lost, since it is based on historical figures and not actual costs, and it fails to take into account the intangible assets and future profitability of the business as the purpose for which the figures were produced does not consider the compensation context and any rules specific to it.³⁰⁴²

While the DCF method provides for the flexibility for determining the full extent of damages incurred by the investor, it should not be used in determining the amount of compensation, where the claim of lost profits is only based on the speculation that an investment would have earned some profits for the remaining period of the relevant contract or license had the assets not been taken. As required by the established rule that damages should be awarded only for the loss the existence of which is proven by the aggrieved party with a reasonable degree of certainty, the decision makers should be particularly reluctant to provide compensation for claims with inherently speculative elements in the context of state party contracts. The claimants are required to demonstrate that an anticipated income stream has attained sufficient attributes to be considered a legally protected interest of sufficient certainty to be compensable as lost profits.³⁰⁴³ Thus, the decision maker should refuse to award damages consisting of lost profits where the business was not a going concern due to the uncertainty as to the existence of loss of profits.

In *Asian Agricultural Products v. Sri Lanka*, which involved a claim for the destruction of the claimant's shrimp farm by security forces, in violation of undertakings to provide “full protection and security” contained in a UK/Sri Lanka investment treaty, the ICSID tribunal granted compensation based on an evaluation of tangible assets, but it rejected all claims for intangible asset and loss of future profit of the newly established business. The tribunal considered that “goodwill” and “profitability” had to be taken into account only to the extent

³⁰³⁸ Wälde, T., *Introductory Note to SVEA Court of Appeals: Czech Republic v. CME Czech Republic B.V.*, *International Legal Materials*, 42 (July 2003), at 917-918.

³⁰³⁹ Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001, Text adopted by the International Law Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission's report covering the work of that session (A/56/10), at 104

³⁰⁴⁰ The World Bank, *Guidelines on the Treatment of Foreign Direct Investment*, *International Legal Materials*, 31 (1992), at 1383

³⁰⁴¹ Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001, Text adopted by the International Law Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission's report covering the work of that session (A/56/10), at 103

³⁰⁴² Friedland, P., & E. Wong, *Measuring Damages for the Deprivation of Income-Producing Assets: ICSID Case Studies*, *ICSID Review—Foreign Investment Law Journal*, 6 (1991), at 405-406

³⁰⁴³ Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001, Text adopted by the International Law Commission at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission's report covering the work of that session (A/56/10), at 104.

that, if proven, they could add a certain premium over the value of the tangible assets that the prospective purchaser would be prepared to pay as the reasonable market value of the business. The tribunal held that the assumptions upon which the claimant's projections were based in the case were insufficient in evidencing that the business was effectively, by the day preceding the events which led to the destruction of the value of the claimant's investment, a "going concern" that acquired a valuable "goodwill" and enjoying a proven "future profitability", particularly in the light of the fact that there was no previous record in conducting business for even one year of production.³⁰⁴⁴

In *Metalclad Corp. v. United Mexican States*, the tribunal determined that Metaclad's investment was completely lost as a result of Mexico's actions, which effectively and unlawfully prevented Metalclad from operating a hazardous waste landfill that it constructed.³⁰⁴⁵ The tribunal stated that "Normally, the fair market value of a going concern which has a history of profitable operation may be based on an estimate of future profits subject to a discounted cash flow analysis."³⁰⁴⁶ However, the tribunal added that, "where the enterprise has not operated for a sufficiently long time to establish a performance record or where it has failed to make a profit, future profits cannot be used to determine going concern or fair market value."³⁰⁴⁷ The tribunal agreed with Mexico that a discounted cash flow analysis was inappropriate in the case because the landfill was never operative and any award based on future profits would be wholly speculative. The tribunal decided that in this case fair market value was best arrived "by reference to Metalclad's actual investment in the project." In other words, the value of the expropriated property was to be determined by the tribunal by estimating the claimant's investment in that property. In the tribunal's view, this approach was consistent with the principles set forth in the *Chorzow* case, "namely that where the state has acted contrary to its obligations, any award to the claimant should, as far as is possible, wipe out all the consequences of the illegal act and reestablish the situation which would in all probability have existed if that act had not been committed (the status quo ante)."³⁰⁴⁸

In the ICSID Case of *Aucoven v. Venezuela*, where Aucoven was forced to abandon a project for the construction and general maintenance of highway systems, the tribunal was disinclined to award lost profits because the claimant had not shown future lost profits with a sufficient degree of certainty under the relevant standards of both Venezuelan and international law. The tribunal stated that "In the present case, the fact remains that Aucoven had no record of profits and that it never made the investments in the project nor built the Bridge required by the Concession Agreement. In these circumstances, the Tribunal considers that Aucoven's claim for future profits does not rest on sufficiently certain economic projections and thus appears speculative. Hence, it does not meet the standards for an award of lost profits under Venezuelan law, nor would it meet these standards under international law, if the latter were applicable."³⁰⁴⁹ The tribunal further considered that "a claim cannot be valued without

³⁰⁴⁴ *Asian Agricultural Products Limited v. Democratic Socialist Republic of Sri Lanka* (ICSID Case No. ARB/87/3), Award and Dissenting Opinion of June 27, 1990, ICSID Review—Foreign Investment Law Journal, 6 (1991), at 564-570

³⁰⁴⁵ *Metalclad Corporation v. United Mexican States*, (ICSID Case No. ARB(AF)/97/1), International Legal Materials, 40 (2001), at 50 para. 106

³⁰⁴⁶ *Ibid.*, at 52 para. 119

³⁰⁴⁷ *Ibid.*, at 52 para. 120

³⁰⁴⁸ *Ibid.*, at 52 para. 122

³⁰⁴⁹ *Autopista Concesionada de Venezuela, C.A. v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/00/5), Award of the Tribunal (September 23, 2003), at para. 362

consideration of its environment, i.e., without consideration of social, economic, political or other factors which may affect it.” Under the circumstances, the tribunal noted that the evidence showed that the project was unlikely to generate profits.³⁰⁵⁰ Thus, the tribunal held that “Aucoven has not established a loss of future profits pursuant to the standards governing under Venezuelan law, being specified that the same conclusion would stand had international law been applicable.”³⁰⁵¹

In the state party disputes, the compensation usually requires cash flow projections, which have an element of speculation associated with it. Thus, lost profits may be awarded in the cases of the temporary loss of use and enjoyment of the income-producing asset, or the taking of income-producing property. In the latter category of cases, lost profits can be awarded on the basis of projections for the period up to the time when the legal recognition of entitlement ends, which depends on the circumstances of a particular case, such as up to the time a valid basis for contractual termination exists. However, the element of speculation increases with the number of years to which a projection relates. Thus, it becomes disputable whether a tribunal can use it at all for the valuation of compensation. The Iran US Claims Tribunal stated, in *Amoco v. Iran*, that “One of the best settled rules of the law of international responsibility of States is that no reparation for speculative or uncertain damage can be awarded. This holds true for the existence of the damage and of its effect as well. Such a rule... does not permit the use of a method which yields uncertain figures for the valuation of damages, even if the existence of damages is certain.”³⁰⁵² As the period of time that forms the basis of the projections into the future increases, they may not be used by the decision maker as the measure of compensation. Particularly, in dealing with the compensation claims for the value of such investments that have an insufficient history of profits for projecting future profitability, the subsequent events, which further render the future profitability of business highly speculative, may support the decision to deny a claim for lost profits on the ground of uncertainty, even if the prospect of profits can be considered as reasonably certain when the investor engaged in the project.

In ICC Case No 3493, the dispute arose from the cancellation by government decrees of a joint venture tourism project between Southern Pacific Properties (SPP), the Ministry of Tourism of Egypt and the Egyptian General Organization of Tourism and Hotels (EGOTH). The tribunal noted that the government initially defended the project in as much as politically feasible and finally gave up and issued the decrees which cancelled the project. Although this background did not exclude a contractual breach by the government, the tribunal was convinced that the breach was not fraudulent or grossly negligent in the sense that it would not be held liable for damages greater than those which could normally have foreseen at the time of entering into contract, as required by Article 221 of the Egyptian Civil Code. The claimant quantified damages on the basis of the discounted cash flow method as of date of cancellation of the project, which produced a figure substantially higher than the amount the claimant actually invested. The tribunal rejected the discounted cash flow calculation in the particular case for a variety of reasons: (i) that the risk factor was much higher than had been assumed in the projections, (ii) that the political and economic climate had a number of new elements unfavorable to the venture’s prospects by the date of cancellation, (iii) that there was a considerable risk in change in the tax status of the venture after the initial five year period,

³⁰⁵⁰ Ibid., at para. 364

³⁰⁵¹ Ibid., at para. 365

³⁰⁵² *Amoco International Finance Corporation v. Islamic Republic of Iran*, Partial Award of 14 July 1987, International Legal Materials, 27 (1988), at para. 238-239

(iv) that the great majority of the work had still to be done by the date of cancellation, (v) that the calculation put forward by the claimant produced a disparity between the amount of the investment made by the claimant and its supposed value at the material date, and (vi) that there was a possibility, although a remote one, that there would be some recovery from the proceedings involving the joint venture company. Thus, the tribunal considered it more appropriate to take the amount of the claimant's actual investment and add to that an incremental factor representing the increase in the value of the investment over its actual cost.³⁰⁵³

In the case *Levitt v. Islamic Republic of Iran*, the Iran US Claims Tribunal recognized that, in principle, lost profits may be awarded in the case of a breach of contract, but denied the claim for such profits due to the failure of the claimant to establish, to the Tribunal's satisfaction, that such profits would have accrued if the contract had proceeded to completion. The dispute arose from a contract between a company, formed by Mr. William J. Levitt, and the Housing Organization of Iran for the construction of housing, together with infrastructure and civic services, on land which the Housing Organization had acquired for the purpose. Due to the Iranian Revolution, the company wound up its operations in Iran after the end of 1979, and Levitt claimed damages comprising expenses allegedly incurred but not reimbursed, and anticipated lost profits due to the alleged breaches by the Organization of its various contractual obligations. The Tribunal held that the Organization was in breach, which rendered further performance by the company impossible, and thus, the organization was liable in damages. While awarding damages for unreimbursed expenses, the Tribunal stated that "the basis for the [lost profits] claim . . . is highly speculative. . . . By the time the Contract came to an end only initial stages of clearing and grading had been completed, and no construction work had begun on buildings. The project therefore reached only an early stage. Initially, the prospects looked favourable. The level of interest shown by prospective purchasers before the Revolution was encouraging, and government approval had been given for the grant of the mortgage financing. Indeed, [the Organization] was obliged by the terms of the Contract to use its best endeavours to obtain such financing. The demand for such housing might well have survived the events of the Revolution. However, the evidence indicates that [the company] would have experienced considerable difficulties in proceeding with the major phases of the construction under the prevalent conditions of disruption and unrest, particularly in view of the fact that it was the first such project Mr. Levitt had undertaken in Iran. It is most unlikely that the project could have been completed according to the time schedule originally envisaged, or that the cost would not have been greatly increased by difficulties in providing supervision by the Levitt organisation and in obtaining imported materials." In this context, the Tribunal found that the claimant did not establish with a sufficient degree of certainty that the project would have resulted in profit.³⁰⁵⁴

It is generally believed that the lawfulness or unlawfulness of the taking of assets has a bearing upon the determination of the quantum of compensation payable in a given case. Where it has been unequivocally established that the taking of assets was in the public interest of the host country and made in a non-discriminatory manner, there exists an obligation to

³⁰⁵³ ICC Award in Case No. 3493, 1983, Yearbook Commercial Arbitration, (1984), at 121-123; However, it should be noted that this award was annulled by Court of Appeal in Paris (Yearbook Commercial Arbitration, 10 (1985), at 113-122) whose decision was upheld by the Cour de Cassation (Yearbook Commercial Arbitration, 13 (1988), at 152-155) on the ground that Egypt was not a party to the agreement on which the claimant relied to found ICC jurisdiction. SPP filed a request for ICSID Arbitration.

³⁰⁵⁴ *Levitt v. Islamic Republic of Iran*, 14 Iran-US C.T.R., (1987), at 209-210

pay compensation according to the market value of the assets on the date of the taking property and in accordance with such formulas “prompt, adequate and effective”, or “just”, “appropriate”, or “equitable” compensation under customary international law.³⁰⁵⁵ The principle on which compensation should be computed in the event of an unlawful taking of private foreign assets is found in the Chorzow Factory case. The Court in Chorzow Factory case made a distinction between legal and illegal expropriations. It is argued that this distinction was based on the Court’s opinion that the expropriation should be illegal in order to be able to award lost profits, i.e. *lucrum cessans*, in addition to the book value of the expropriated business, i.e. *damnum emergens*.³⁰⁵⁶

However, in most cases, the value of an enterprise is not only the enterprise itself, but also the stream of profits it can be expected to produce over its lifetime, and this value determines the price that the hypothetical willing buyer would pay the hypothetical willing seller. In this

³⁰⁵⁵ Reisman, W. Michael, & R.D. Sloane, *Indirect Expropriation and its Valuation in the BIT Generation*, *British Yearbook of International Law*, 74 (2003), at 134; Weisburg, Henry, & Christopher Ryan, *Means to be Made Whole: Damages in the Context of International Investment Arbitration*, in Yves Derains & Richard H. Kreindler, (eds.), *Evaluation of Damages in International Arbitration*, ICC Publication No. 668, 2006, at 167; *Shahin Shaine Ebrahimi v. Iran*, Iran-US Cl. Trib. Award 560-44/46/47-3 of 12 October 1994, at para. 88: “The Tribunal believes that, while international law undoubtedly sets forth an obligation to provide compensation for property taken, international law theory and practice do not support the conclusion that the “prompt, adequate and effective” standard represents the prevailing standard of compensation. ... Rather, customary international law favors an “appropriate” compensation standard. ... The gradual emergence of this rule aims at ensuring that the amount of compensation is determined in a flexible manner, that is, taking into account the specific circumstances of each case. The prevalence of the “appropriate” compensation standard does not imply, however, that the compensation quantum should be always “less than full” or always “partial.””; *Compañía del Desarrollo de Santa Elena S.A. v. Republic of Costa Rica* (ICSID Case No. ARB/96/1), February 17, 2000, ICSID Review—Foreign Investment Law Journal, 15 (2000), at 192, para. 69: “The vocabulary describing the amount of compensation properly payable in respect of a lawful taking has varied considerably from time to time. It comprises such words as “full”, “adequate”, “appropriate”, “fair” and “reasonable”. Sometimes, the descriptive adjective is elaborated by the additional mention of “market value”; *Libyan American Oil Co. (LIAMCO) v. Libyan Arab Republic*, *Yearbook Commercial Arbitration*, (1981), at 110, 113: “The classical doctrine required the payment of “prompt, adequate and effective” compensation for the nationalized property of an alien... This classical doctrine was not always accepted neither in the inter-war period nor after World War II. ... It retains only the value of a technical rule for the assessment of compensation, and a useful guide in reaching settlement agreement, as was well and justly asserted... It stands only as a maximum rarely attained in practice.... In such confused state of international law, as is evident from the foregoing precedents and authoritative opinions and declarations, it appears clearly that there is no conclusive evidence of the existence of community or uniformity in principles between the domestic law of Libya and international law concerning the determination of compensation for nationalization in lieu of specific performance, and in particular concerning the problem whether or not all or part of the loss of profits (*lucrum cessans*) should be included in that compensation in addition to the damage incurred (*damnum emergens*)... In compliance with Clause 28, para. 7, of LIAMCO’s Concession Agreements, and in such absence of principles common to domestic law of Libya and international law applicable to the matters in dispute, it is necessary to refer therefore to the general principles of law as may have been applied by international tribunals. ‘One of these general principles of law is Equity, which is commonly and unanimously recognized as a supplementary source of law in Libyan law (Article I of the Civil Code), Islamic law (*Istihsan*) and international law (Article 39, para. 2, of the Statute of the International Court of Justice). Taking Equity into consideration, it would be reasonable and just to adopt the formula of “equitable compensation” as a measure for the estimation of damages in the present dispute. This formulation is certainly in complete harmony with the general trend of international theory and practice on the concepts of sovereignty, destination of national wealth and natural resources, nationalistic motivations in the attitude and behavior of “Third World” nations, the lawfulness and frequency of nationalization, and the recent declarations affirmed in successive United Nations Resolutions by the majority members of the General Assembly.”

³⁰⁵⁶ Brownlie, Ian, *Principles of public international law*, Oxford University Press, 7th ed., 2008, at 539; Hunter, Martin & Anthony Sinclair, *Aminoil Revisited: Reflections on a Story of Changing Circumstances*, in Todd Weiler (ed.), *International Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law*, Cameron May, 2005, at 366

regard, the argument that, in an unlawful expropriation, the victim must be awarded the value of the expropriated property and lost profits implies a form of double-counting. Thus, it is alternatively argued that the difference between legal and illegal expropriation might be reflected in the so-called “moral damages”³⁰⁵⁷ or in the component of *lucrum cessans* to penalize egregious expropriations and to deter them in the future³⁰⁵⁸. In essence, the principle established by the Court in the Chorzow case provides an important guideline about the effect of the events subsequent to the expropriation on the amount of damages recoverable by the investors.

The Court in Chorzow Factory case established the standard to value damages for illegal expropriations as of the date of the award, as an alternative to the calculation of such damages as of the date of expropriation, thereby allowing damages to be computed as the greater of the fair market value at the date of the expropriation and at the date of the award. The Court stated that “the compensation due to the German Government is not necessarily limited to the value of the undertaking at the moment of dispossession, plus interest to the day of payment. This limitation would only be admissible if the Polish Government had had the right to expropriate, and if its wrongful act consisted merely in not having paid ... the just price of what was expropriated; in the present case, such a limitation might result in placing Germany and the interests protected by the Geneva Convention, on behalf of which interests the German Government is acting, in a situation more unfavourable than that in which Germany and these interests would have been if Poland had respected the said Convention. Such a consequence would not only be unjust, but also and above all incompatible with the aim of Article 6 and following articles of the Convention—that is to say, the prohibition, in principle, of the liquidation of the property, rights and interests of German nationals and of companies controlled by German nationals in Upper Silesia—since it would be tantamount to rendering lawful liquidation and unlawful dispossession indistinguishable in so far as their financial results are concerned.”³⁰⁵⁹

Accordingly, the Court in Chorzow Factory case asked the experts to compute the fair market value of the factory at the date of expropriation (Question 1A), to value the financial results (profits or losses) for the interim period between the date of expropriation and the date of indemnification if the expropriation had not occurred (Question 1B), and to compute the fair market value of the factory as of the date of the award if it had remained in the hands of the expropriated owners, and had either remained substantially as it was at the date of expropriation or had been developed proportionately on lines similar to those applied in the

³⁰⁵⁷ Park, William W., “Framing the Case on Quantum” in *Damages in International Arbitration*, *World Arbitration & Mediation Review*, 2 (2008), at 61 citing *Desert Line Projects LLC v. Yemen*, ICSID Case No. ARB/05/17 (Award) (Feb. 6, 2008), at paras. 289-290: In the case, armed individuals, threatening the investor’s personnel, were used to expel the investor, which was building asphalt roads in Yemen. The ICSID tribunal found that the violation of the BIT by the respondent, in particular the physical duress exerted on the executives of the claimant, was malicious and is therefore constitutive of a fault-based liability. Therefore, the tribunal stated that the respondent shall be liable to reparation for the injury suffered by the claimant, whether it be bodily, moral or material in nature. According to the tribunal, the claimant’s prejudice was substantial since it affected the physical health of the claimant’s executives and the claimant’s credit and reputation. The tribunal considered that, based on the information it had and the general principles, an amount of USD 1,000,000 should be granted for moral damages, including loss of reputation. The tribunal noted that this amount is more than symbolic yet modest in proportion to the vastness of the project.

³⁰⁵⁸ Reisman, W. Michael, & R.D. Sloane, *Indirect Expropriation and its Valuation in the BIT Generation*, *British Yearbook of International Law*, 74 (2003), at 137

³⁰⁵⁹ *Factory at Chorzów (Claim for Indemnity) (Merits) (F.R.G. v. Pol.)*, 1928 Permanent Court of International Justice, Series A, No. 13 (September 13, 1928), at 47

case of other undertakings of the same kind, controlled by the expropriated owners (Question 2).³⁰⁶⁰

The Court explained that the purpose of Question 1 was “to determine the monetary value, both of the object which should have been restored in kind and of the additional damage, on the basis of the estimated value of the undertaking including stocks at the moment of taking possession by the Polish Government, together with any probable profit that would have accrued to the undertaking between the date of taking possession and that of the expert opinion”. The Court stated that Question 2 was to ascertain the value at the date of the award, leaving aside the situation presumed to exist at the date of expropriation, and the Court considered that the hypothetical nature of this question was considerably diminished by the possibility of comparison with other undertakings of the same nature directed by the expropriated owners.³⁰⁶¹ As regards the *lucrum cessans*, in relation to Question 2, the Court noted that the cost of upkeep of the corporeal objects forming part of the undertaking and even the cost of improvement and normal development of the installation and of the industrial property incorporated therein, are bound to absorb in a large measure the profits, real or supposed, of the undertaking and, thus, up to a certain point, any profit may be left out of account, since it will be included in the real or supposed value of the undertaking at the date of award. However, the Court stated that if the reply given by the experts to Question 1B should show that there remained a margin of profit after making necessary deductions for the years during which the factory was working at a loss, and for the cost of upkeep and normal improvement during the following years, the amount of such profit should be added to the compensation to be awarded. According to the Court, if the normal development presupposed by Question 2 represented an enlargement of the undertaking and an investment of fresh capital, the amount of such sums must be deducted from the value sought for.³⁰⁶²

Thus, the Court implied that, in cases of illegal expropriation, damages were to be computed either as the fair market value at the date of the expropriation, or as the fair market value at the date of the award, and the fair market value could include the lost profits. In both cases, the lost profits relating to the interim period between the date of expropriation and the date of award could be based on the historical data that was available to the experts, who would utilize such data on the basis of the assumption that the factory remained with the expropriated owners. The concept of *lucrum cessans* as developed in the Chorzow factory case related to the interim period between the date of expropriation and the date of the award, where the relevant information is available to and may be used by the ex post decision maker.

Thus, the concept of *lucrum cessans* in the Chorzow factory case is distinct from the concept of fair market value, which already includes all future lost profits if there is sufficient history of profits, from the date of expropriation to the end of the project. This fair market value can be calculated according to the DCF method, and this value, despite the defects of the DCF method mentioned above, has still a good chance to reflect an amount that a willing buyer would normally pay to a willing seller after taking into account the nature of the investment, by taking into account some important variables, including the period in which it has been in existence, and other relevant factors pertinent to the particular circumstances of the case. Under the Chorzow Factory standards, the compensation in cases of illegal expropriation will

³⁰⁶⁰ Ibid., at 51-52

³⁰⁶¹ Ibid., at 52

³⁰⁶² Ibid., at 53

be the fair market value of the undertaking, either at the date of the expropriation or at the date of award. In both cases, the compensation includes the profits, which would have been earned after the relevant date, had the expropriation not occurred, and the portion of the profits relating to the period between the date of expropriation and the date of the award may be determined on the basis of the actual data. The profits determined on the basis of the actual data will be considered as absorbed to a great extent by the investment, when the valuation is made as of the date of award, but if there remains a margin of profit, it will be added to the fair market value of the investment as of the date of award. In this context, the amount of compensation under these alternatives of valuation may yield the identical result and confirm each other, when they are both calculated according to the same method. If, on the contrary, these amounts had been different, the Court in the Chorzow Factory case expressly and fully reserved its right to review the expert's valuations and to determine the sum to be awarded in conformity with the legal principles set out in the judgment by making the necessary adjustments.³⁰⁶³ The choice between the two alternatives was never made because the parties reached an out of court settlement. Conceivably, had the alternative of valuation as of the date of award yielded a value, which was lower than the value at the time of the expropriation, the higher value would have prevailed.³⁰⁶⁴

The approach of Chorzow factory case highlights the importance of hindsight information in evaluating the amount of damages and the consideration of ex post risks, up to the time of the award, associated with the expropriated investment, in cases of unlawful expropriations.³⁰⁶⁵ If the investment has increased in value in the absence of state measures in the interim period between the date of the expropriation and the date of the award, the state ought not to benefit from its illegal actions that lead to taking advantage of a rising market without a genuine public interest, and the amount of compensation should be calculated by the alternative standard of valuation at the date of the award.³⁰⁶⁶ If the investment has lost value in the same period in the absence of state measures, the state ought not to benefit by paying a lower compensation and, thus, the compensation should be valued as of the date of

³⁰⁶³ Ibid., at 53-54

³⁰⁶⁴ For the same interpretation see Iran-US Claims Tribunal, *Amoco Int'l Finance Corp. v. Iran*, 15 IRAN-U.S. C.T.R., at 250, para. 204 (stating in a footnote that "This does not seem to have been questioned by any of the judges, although Judge Rabel, in "observations" appended to the judgment, expressed his regrets that this was not expressly said by the Court. The other judges dissenting on this point considered that the compensation should be limited to the value of the undertaking at the date of the taking without any right to an enhanced value.")

³⁰⁶⁵ Abdala, Manuel A., & Pablo T. Spiller, *Chorzów's Standard Rejuvenated Assessing Damages in Investment Treaty Arbitrations Chorzów's Standard Rejuvenated*, *Journal of International Arbitration*, 25-1 (2008), at 108

³⁰⁶⁶ In *Siemens v Argentina*, the ICSID tribunal stated that "Under customary international law, Siemens is entitled not just to the value of its enterprise as of May 18, 2001, the date of expropriation, but also to any greater value that enterprise has gained up to the date of this Award, plus any consequential damages." The tribunal also noted that "In the Factory at Chorzów case, the PCIJ asked the experts to calculate the value of the undertaking as of the date of the taking and as of the later date of its prospective judgment, and such value to include the lands, buildings, equipment, stocks and process, supply and delivery contracts, goodwill and future prospects. It is only logical that, if all the consequences of the illegal act need to be wiped out, the value of the investment at the time of this Award be compensated in full. Otherwise compensation would not cover all the consequences of the illegal act." The tribunal concluded that "the value of the investment to be compensated is the value it has now, as of the date of this Award, unless such value is lower than at the date of expropriation, in which event the earlier value would be awarded." *Siemens A.G. v. Argentine Republic* (ICSID Case No. ARB/02/8), Award rendered on February 6, 2007, paras. 352, 353, 360

expropriation.³⁰⁶⁷ In both cases, the Chorzow standards of valuation function to preclude the possibility of the expropriating state to benefit from its own illegal act, given that the investor was forced to transfer its investment to the state, and prevented from exercising the option of selling it at arm's length when the business conditions were better.

In the ICSID Case of ADC Affiliate Limited and ADC & ADMC Management Limited v Republic of Hungary, where the issue was damages payable in the case of an unlawful expropriation, the tribunal stated that the customary international law standard for the assessment of damages resulting from an unlawful act is set out in the Chorzow Factory case, and this standard has subsequently been affirmed and applied in a number of international arbitrations relating to the expropriation of foreign owned property.³⁰⁶⁸ The tribunal stated that "The present case is almost unique among decided cases concerning the expropriation by States of foreign owned property, since the value of the investment after the date of expropriation (1 January 2002) has risen very considerably while other arbitrations that apply the Chorzów Factory standard all invariably involve scenarios where there has been a decline in the value of the investment after regulatory interference. It is for this reason that application of the restitution standard by various arbitration tribunals has led to use of the date of the expropriation as the date for the valuation of damages."³⁰⁶⁹ According to the tribunal, in the case, the application of the Chorzow Factory standard required that the date of valuation should be the date of the award and not the date of expropriation, since this is what is necessary to put the claimants in the same position as if the expropriation had not been committed. The tribunal found support for this approach in the statement of the Court in the

³⁰⁶⁷ In *Amoco v. Iran*, Judge Brower in his concurring opinion, suggested, when the value of the undertaking as it appears at the time of judgment is awarded is less than the value assessed as of the date of taking, it would have the anomalous result of rewarding the expropriating state for its unlawful conduct. In this regard, Judge Brower stated that, "Absent any consequential damages, which the Court in Chorzow Factory would award, or consideration of punitive damages, which the Award here flatly rejects ..., the host State would pocket the difference between the lower value the undertaking was shown by post-taking experience to have had and the higher value it objectively enjoyed at the moment of taking. As no system of law sensibly can be understood as intended to reward unlawful conduct, Chorzow Factory must be read as I have suggested, a reading supported by other portions of the judgment (see, e.g., the statement at page 50 that "the value of the undertaking at the moment of dispossession does not necessarily indicate the criteria for the fixing of compensation") and the Observations of Judge M. Rabel: "[T]he principles resulting from the unlawful nature of the expropriation . . . are applicable in practice whenever the damage caused appears greater than the compensation which would be due if expropriation had been lawful It is in fact obvious that the expropriator's responsibility must be increased by the fact that his action is unlawful [I]t is . . . also obvious that the unlawful character of his action can never place the expropriator in a more favourable position . . . by reducing the indemnity due This point of view, with which the Court in its judgment has not thought fit expressly to deal, appears to me to be in accordance with the general principles of law." 28 P.C.I.J., Ser. A, No. 17 at 66. This understanding of the judgment is confirmed by the Dissenting Opinions of Judges Lord Finaly, *id.* at 73, and M. Ehrlich, *id.* at 90. The Award here correctly accepts this reading of Chorzow Factory." Concurring Opinion, *Iran-United States Claims Tribunal: Partial Award in Amoco International Finance Corporation v. Islamic Republic of Iran*, International Legal Materials, 27 (1988), at 1399-1400 fn 22

³⁰⁶⁸ *ADC Affiliate Limited and ADC & ADMC Management Limited v. Republic of Hungary* (ICSID Case No. ARB/03/16) October 2, 2006, at para. 484-486; citing *S.D. Myers, Inc. v. Canada*, UNICTRAL (NAFTA) Award (Merits), 13 November 2000, at para.311, *Metalclad Corporation v. Mexico*, ICSID Case No. ARB(AF)/97/1, Award, 30 August 2000, at para. 122, *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Award, Case No. ARB/01/8, 12 May 2005, at para.400, *Petrobart Limited v. The Kyrgyz Republic*, Arbitration No. 126/2003, Arbitration Institute of the Stockholm Chamber of Commerce (Energy Charter Treaty), 29 March 2005, at pages 77 and 78, *MTD Equity Sdn Bhd and MTD Chile SA v. Chile*, ICSID Case No. ARB/01/7, 25 May 2004, para.238

³⁰⁶⁹ *ADC Affiliate Limited and ADC & ADMC Management Limited v. Republic of Hungary* (ICSID Case No. ARB/03/16) October 2, 2006, at para. 496

Chorzow Factory case that damages are “not necessarily limited to the value of the undertaking at the moment of dispossession” and in the decisions of Iran US Claims Tribunal³⁰⁷⁰ and the European Court of Human Rights³⁰⁷¹. The tribunal concluded that it must assess the compensation to be paid by the respondent to the claimants in accordance with the Chorzow Factory standard, i.e., the claimants should be compensated the market value of the expropriated investments as at the date of the award and preferred to apply the DCF method in calculating the final amount of damages.³⁰⁷² The tribunal stated that the claim for damages under this approach fell into two parts: (a) the estimated value of the claimants’ stake in the project company as of the award date; and (b) all unpaid dividends and management fees from the date of expropriation until the date of the award.³⁰⁷³

The Chorzow’s compensation criterion should not be interpreted to the effect of adding some punitive element to the valuation of damages or leading to double counting of the recoverable damages, as those would contradict the basic premises of the principle of full compensation. The Chorzow decision should be construed as implying that, the state, which unlawfully expropriates a going concern and, thereby, prevents the investor from selling its undertaking when the business conditions were better, residually assumes the risk that the increase in the value of the undertaking, due to the changing business conditions during the interim period between the date of expropriation and the date of the award, will be reflected to the amount of damages payable by the state to the investor. Thus, the value of the relevant undertaking, in cases of both lawful and unlawful expropriation, may, in principle, be determined on the basis of the projections and business conditions that existed at the time of expropriation, but in case of unlawful expropriation, the value of the undertaking will exceptionally reflect the increase resulting from the business conditions that have improved by the time of the award. Due to such a risk allocation between the parties, the Chorzow decision can be considered as comparable to the exception to the principle of foreseeability of loss by the party in breach at the time of contracting under some national legal systems, which prevents the party in breach from invoking the foreseeability limitation in cases of intentional or fraudulent breach of the contract. Thus, in the calculation of the damages arising from the unlawful expropriations, the effect of changing business conditions that increase the value of the undertaking and, thus, the amount of compensation will be taken into account, regardless of whether the relevant events subsequent to the expropriation were unforeseeable by the state party at the time of expropriation, as a result of residual risk allocation under the customary international law.

In Amco II Award, the issue of foreseeability was raised by the defendant state in order to limit the amount of damages recoverable by the claimant due to unlawful state measures. The ICSID tribunal found that the general background to the decision of Indonesia to revoke Amco’s investment license in 1980 constituted a denial of justice, and caused harm to Amco through an unlawful action.³⁰⁷⁴ The tribunal held that, as with Indonesian law, the loss must be attributable to the wrongful act and foreseeable, and non-speculative loss may be

³⁰⁷⁰ Amoco International Finance Corporation v. Iran, 15 IRAN–U.S. C.T.R., at 189 and 247 para.196

³⁰⁷¹ Papamichalopoulos v Greece (A/330-B), European Court of Human Rights, 31 October 1995, (1996) 21 E.H.R.R. 439

³⁰⁷² ADC Affiliate Limited and ADC & ADMC Management Limited v. Republic of Hungary (ICSID Case No. ARB/03/16) October 2, 2006, at para. 499 and 514

³⁰⁷³ Ibid., at para. 518

³⁰⁷⁴ Final award of 5 June 1990 in case no. ARB/81/8 and Decision on Supplemental Decision and Rectification of 17 October 1990, ICSID Award, AMCO Asia Corp. et al. v. The Republic of Indonesia, Yearbook Commercial Arbitration, (1992), at 98

recovered. Indonesia argued that, if compensation was due at all, only those foregone profits that could be foreseen in 1980 were compensable. The tribunal rejected this argument. It referred to the *Chorzow* decision with regard to the principle that, in an unlawful nationalization, there must be restitution to establish the situation that would otherwise have existed, or, “if this is not possible, payment of a sum corresponding to the value which restitution in kind would bear”.³⁰⁷⁵ The tribunal stated that “If the purpose of compensation is to put Amco in the position it would have been in had it received the benefits of the Profit-Sharing Agreement, then there is no reason of logic that requires that to be done by reference only to data that would have been known to a prudent businessman in 1980. It may, on one view, be the case that in a lawful taking, Amco would have been entitled to the fair market value of the contract at the moment of dispossession. In making such a valuation, a Tribunal in 1990 would necessarily exclude factors subsequent to 1980. But if Amco is to be placed as if the contract had remained in effect, then subsequent known factors bearing on that performance are to be reflected in the valuation technique.” According to the tribunal, foreseeability is linked to causation, rather than to the quantum of profit, and it would be an inappropriate test for such damages that approximate to *restitutio in integrum*. The tribunal concluded that while subsequent known events of a general nature may appropriately be an element in the valuation process, the effects of the taking itself must be excluded, since it is well established in international law that the value of property or contract rights must not be affected by the unlawful act that removed those rights.³⁰⁷⁶

The tribunal further stated that “where there has been an unlawful taking of contract rights, lost profits are in principle recoverable”. The tribunal’s findings applied to non-speculative profits that would have been due to Amco over the remaining period of the contract.³⁰⁷⁷ The tribunal divided its assessment of profits lost by Amco as a result of Indonesia’s wrongful conduct into two periods: (1) period preceding the award (from 1980 until the end of 1989); and period subsequent to the award (from 1990 until 1999). As the first period of 1980-1989 referred to the past, the tribunal used known data for relevant factors, including the year-by-year inflation rate, as well as actual exchange and taxation rates.³⁰⁷⁸ From 1 January 1990 (1989 being the last full year for which known factors are available) onwards, the tribunal found the DCF method “appropriate to establish the net present value of PT Amco’s rights for the remaining period of the lease, by capitalizing earnings and expenditures which would otherwise have been spread over the future years of the life of the 1978 Profit Sharing Agreement.”³⁰⁷⁹ According to the tribunal, the DCF method is entirely consistent with Indonesian law and international law. The tribunal emphasized that the DCF method was “not a mechanistic device”. It stated that “The method itself relies on the application of assumptions which are necessarily judgmental. The DCF method is at once a flexible tool, that allows for an application of factors and elements judged as relevant. At the same time, it allows for the application of these judgmental elements to be articulated.”³⁰⁸⁰ In determining the amount of lost profits, the tribunal did not use the actual profits earned during the interim period between 1980 and 1989 by the management that overtook the undertaking from Amco, but instead took the average monthly net profit for the period between 1979 and 1980, when

³⁰⁷⁵ *Ibid.*, at 101

³⁰⁷⁶ *Ibid.*, at 101-102

³⁰⁷⁷ *Ibid.*, at 99

³⁰⁷⁸ *Ibid.*, at 103-104

³⁰⁷⁹ *Ibid.*, at 104

³⁰⁸⁰ *Ibid.*, at 104-105

Amco actually was managing the undertaking, as a basis for the interim period between 1980 and 1989, and adjusted this base-period profit to account for inflation and other factors, already known at the time of the award. The tribunal, then, used the profits figure for the year 1989 obtained under this analysis for the remaining period between 1990 and 1999, and discounted the resulting amount by the sum of the inflation rate and the risk factor. The tribunal adopted a relatively low risk factor for such reasons that the level of assumed profit had been kept steady in real terms, and the projected earnings had been based on known historic results.

The measure of compensation as contemplated by the Court in Chorzow Factory case is only relevant to the event of an unlawful expropriation. Thus, it is not applicable in cases of lawful expropriation. However, as stated by the Iran US Claims Tribunal, “the lawful/unlawful taking distinction, which in customary international law flows largely from the Case Concerning the Factory at Chorzow ..., is relevant only to two possible issues: whether restitution of the property can be awarded and whether compensation can be awarded for any increase in the value of the property between the date of taking and the date of the judicial or arbitral decision awarding compensation. The Chorzow decision provides no basis for any assertion that a lawful taking requires less compensation than that which is equal to the value of the property on the date of taking.”³⁰⁸¹

In the Aminoil case, it seemed that the characterization of the expropriation as lawful or unlawful would not affect the final amount of compensation due to the investor. The case concerned an oil concession that was granted in 1948 by Kuwait to Aminoil for a period of sixty years. In November 1974, three Gulf States met at Abu Dhabi and resolved to increase royalties to 20 per cent and income tax to 85 per cent of posted prices, effective immediately. This became known as the “Abu Dhabi formula”, and it was adopted by OPEC in December 1974.³⁰⁸² Negotiations then took place in the next period between Kuwait and Aminoil, concerning, the application of the “Abu Dhabi Formula”. In 1977, Kuwait passed Decree Law No 124, which provided that Aminoil’s concession should be terminated, that Aminoil’s assets in Kuwait should revert to the state, and that ‘fair’ compensation should be paid to Aminoil.³⁰⁸³ Aminoil argued that the concession contained provisions that, in their combined effect, to constitute a “stabilisation clause” and to preclude the Government from terminating or varying the concession unilaterally.³⁰⁸⁴

The ad hoc tribunal stated that the case of nationalization was certainly not expressly provided against by the stabilization clauses of the concession, and rejected the argument of Aminoil that notwithstanding this gap, the stabilization clauses were cast in such absolute and all-embracing terms as to suffice in themselves, unconditionally and in all circumstances, for prohibiting nationalization. The tribunal considered that although contractual limitations on the state's right to nationalize are possible, it would have to be expressly stipulated for, and it should cover only a relatively limited period given the particularly serious nature of such an undertaking. However, according to the tribunal, the relevant provisions were far from having lost all their value and efficacy since, by impliedly requiring that nationalization shall not

³⁰⁸¹ Phillips Petroleum Company Iran v. The Islamic Republic of Iran, 21 IRAN-U.S. C.T.R., (1989), at 122, para. 110

³⁰⁸² Ad-Hoc-Award, Kuwait v. The American Independent Oil Company (AMINOIL), International Legal Materials, 21 (1982), at 995

³⁰⁸³ Ibid., at 998

³⁰⁸⁴ Ibid., at 1020 para. 88

have any confiscatory character, they reinforce the necessity for a proper indemnification as a condition of it. The tribunal also stated that “While attributing its full value to the fundamental principle of *pacta sunt servanda*, the Tribunal has felt obliged to recognize that the contract of concession has undergone great changes since 1948: changes conceded often unwillingly, but conceded nevertheless - by the company. These changes have not been the consequence of accidental or special factors, but rather of a profound and general transformation in the terms of oil concessions that occurred in the Middle-East, and later throughout the world. These changes took place progressively, with an increasing acceleration, as from 1973. They were introduced into the contractual relations between the Government and Aminoil through the play of [an adaptation clause], or else as the result of at least tacit acceptances by the Company, which entered neither objections nor reservations in respect of them. These changes must not simply be viewed piece-meal, but on the basis of their total effect, - and they brought about a metamorphosis in the whole character of the Concession.”³⁰⁸⁵

The tribunal held that the concession had become over time a contract governed by a changed regime in which, as “in most legal systems, the state while remaining bound to respect the contractual equilibrium, enjoys special advantages.” The tribunal emphasized that the case was neither one of a fundamental change of circumstances (*rebus sic stantibus*), nor a case of a change involving a departure from a contract, but a change in the nature of the contract itself, brought about by time, and the acquiescence or conduct of the parties.³⁰⁸⁶ Thus, the tribunal concluded that the nationalization in 1977 was not inconsistent with the contract of concession, provided always that the nationalization did not possess any confiscatory character.³⁰⁸⁷ The tribunal considered that Decree Law No 124, where the government had provided that fair compensation should be paid, did not constitute a violation by Kuwait of its obligations towards Aminoil, as these stood in 1977.³⁰⁸⁸

As to the standard of damages, the tribunal first made a general observation that the determination of an indemnification has always presented technical difficulties, not only in regard to indemnifications due in consequence of illicit acts, where it is as the equivalent of a *restitutio in integrum* that the calculation is in principle effected, but also for indemnities due in consequence of acts of expropriation or of legitimate nationalizations. The tribunal noted that in the latter case, the difficulties are added to by controversial questions of foreign investments, and operations involving an important economic complex.³⁰⁸⁹ The tribunal observed two tendencies in the approaches of different states: one of which seeks to “reduce compensation almost to the status of a symbol”, and the other “assimilates the compensation due for a legitimate take-over to that due in respect of illegitimate one”.³⁰⁹⁰ According to the tribunal, the most general formulation of the rules applicable for a lawful nationalization was contained in the UNGA Resolution 1803, which provided that in cases of nationalization, “the owner shall be paid appropriate compensation”. The tribunal did not attempt to determine the general principles underlying the notion of “appropriate” compensation, but considered that the determination of the amount of an award of “appropriate” compensation is better carried

³⁰⁸⁵ Ibid., at 1023 para. 97

³⁰⁸⁶ Ibid., at 1023 para. 101

³⁰⁸⁷ Ibid., at 1023 para. 102

³⁰⁸⁸ Ibid., at 1027 para. 115

³⁰⁸⁹ Ibid., at 1031 para. 138

³⁰⁹⁰ Ibid., at 1032 para. 143

out by means of an enquiry into all the circumstances relevant to the particular concrete case, than through abstract theoretical discussion.³⁰⁹¹ Moreover, it decided to confine itself to registering that in the case there was no room for rules of compensation that would make nonsense of foreign investment.³⁰⁹² Both parties invoked the notion of “legitimate expectations” for deciding on compensation. The tribunal based its approach on this notion, and stated that: “That formula is well advised, and justifiably brings to mind the fact that, with reference to every long-term contract, especially such as involve an important investment, there must necessarily be economic calculations, and the weighing-up of rights and obligations, of chances and risks, constituting the contractual equilibrium. This equilibrium cannot be neglected — neither when it is a question of proceeding to necessary adaptations during the course of the contract, nor when it is a question of awarding compensation. It is in this fundamental equilibrium that the very essence of the contract consists.”³⁰⁹³ For assessment of that equilibrium and the determination of the legitimate expectations of the parties, the tribunal took into account not only the text of contract, but also the amendments, the interpretations, and the behavior manifested along the course of its existence.

In ascertaining the basis of Aminoil's compensation, the tribunal first noted that the concession did not expressly provide for the possibility of a termination prior to the maturity of the concession, but merely provided that at the expiry of the sixty-year period of the concession, the entire undertaking should be handed over to the Government without compensation. The tribunal did not consider this solution as being appropriate to the circumstances.³⁰⁹⁴ In order to determine the factors that have to be taken into account for the indemnification of Aminoil, the tribunal considered the arguments of the parties. Aminoil suggested a choice between two methods: (i) a method based on the sum total of the anticipated profits, reckoned to the natural termination of the Concession, but discounted at an annual rate of interest and without taking account of the value of the assets that would have been transferred to Kuwait without compensation upon that termination; and (ii) a method whereby total anticipated profits are counted and discounted in the same way over a limited period of years only, but taking countervailing account of the value of the assets.³⁰⁹⁵ The tribunal agreed in principle that both of the methods suggested by Aminoil are acceptable, and preferred to employ a combination of methods, according to the different factors that have to be taken into account. However, the tribunal disagreed with Aminoil's assumptions and calculations on two basic points. First, the tribunal disagreed with the Aminoil's calculation of anticipated profits on the exclusive basis of the financial arrangements of 1961, and decided to take into account the combination of later arrangements, including the negotiations between the parties about the application of the “Abu Dhabi formula”. Secondly, the tribunal stated that Aminoil's projection had not been based on the “reasonable rate of return”, a concept adopted by the parties in the course of their relations and negotiations.³⁰⁹⁶

The tribunal rejected the “net book value” method proposed by Kuwait as a particular rule, of an international and customary character, specific to the oil industry, which, Kuwait claimed, generated “a *lex petrolea* that was in some sort a particular branch of a general universal *lex*

³⁰⁹¹ Ibid., at 1033 para. 144

³⁰⁹² Ibid., at 1033 para. 146

³⁰⁹³ Ibid., at 1034 para. 148

³⁰⁹⁴ Ibid., at 1034 para. 151

³⁰⁹⁵ Ibid., at 1034 para. 152

³⁰⁹⁶ Ibid., at 1035 para. 154

mercatoria.”³⁰⁹⁷ In this regard, the tribunal noted that the precedents of compensation for nationalization, to which Kuwait referred, were reached through negotiations rather than arbitrations, and their results had usually been a complex deal between an investor and a state, which involved, in addition to compensation for a nationalized concession, a preferential relationship, prospects for future advantages or other arrangements suitable to the investor. According to the tribunal, those precedents had not constituted an expression of *opinio iuris* and therefore could not be viewed as rules of international law. The tribunal stated that consents of investors had been given under the pressure of very strong economic and political constraints, which had nothing to do with law, and could not enable them to be regarded as components of the formation of a general legal rule.³⁰⁹⁸

Subsequently, the tribunal examined the basis on which the evaluation of the legitimate expectations of Aminoil must proceed. First, the tribunal recalled that whereas the contract of concession did not forbid nationalization, the stabilization clauses inserted in it were nevertheless not devoid of all consequence, for they prohibited any measures that would have had a confiscatory character. According to the tribunal, these clauses created for the concessionaire a legitimate expectation that must be taken into account.³⁰⁹⁹ The tribunal considered Aminoil in the position of an undertaking whose aim was to obtain a “reasonable rate of return” and not speculative profits. The tribunal stated that, although the attitudes taken up by a party over the long course of a negotiation that eventually broke down could not be made the basis of an arbitral or judicial decision, there was no question in the case that, over the years, Aminoil had come to accept the principle of a moderate estimate of profits, and that it was this that constituted its legitimate expectation.³¹⁰⁰ In this context, the tribunal decided to assess separately “the value, on the one hand of the undertaking itself, as a source of profit, and on the other of the totality of the assets”, and to add together the results obtained.³¹⁰¹

As to the method for valuing the physical assets, the tribunal stated that the “net book value” would be suitable only in cases of recent investment, where the original cost of assets was not far from the present replacement cost. In other cases, taking account the pace of inflation, the tribunal considered that “it would be unfair” to calculate the value of depreciating assets “on the basis of a superannuated cost consisting of the original purchase price, when that price has no relation to the actual present cost.” The tribunal stated that the “net book value merely gives a formal accounting figure which, in the present case, cannot be considered adequate.”³¹⁰² Thus, the tribunal considered appropriate a depreciated replacement value. On this basis, fixed assets were evaluated. For non-fixed assets, the tribunal relied on the figures in the joint report, without explanation of the valuation method used.³¹⁰³ In the valuation of the undertaking as going concern, the tribunal stated that it considered the undertaking itself “as an organic totality – or going concern – therefore as a unified whole, the value of which is greater than that of its component parts, and which must also take account of the legitimate expectations of the owners”. However, the tribunal did not separately quantify, in the award,

³⁰⁹⁷ Ibid., at 1035 para. 155

³⁰⁹⁸ Ibid., at 1036-1037 para. 157

³⁰⁹⁹ Ibid., at 1037 para. 159

³¹⁰⁰ Ibid., at 1037 para. 161

³¹⁰¹ Ibid., at 1038 para. 164

³¹⁰² Ibid., at 1041-1042 para.178(2)

³¹⁰³ Ibid., at 1042 para.178(3)

an amount of compensation for the undertaking as a going concern, but stated that “These principles remain good even if the undertaking was due to revert, free of cost, to the concessionary Authority in another 30 years, the profits having been restricted to a reasonable level.”³¹⁰⁴ The tribunal neither specified the number of years it used to calculate Aminoil’s return.

Thus, the tribunal summed up the values of the fixed and non-fixed assets and took account of the legitimate expectations of the concessionaire to calculate the overall amount of compensation due when Decree Law No 124 was passed. The award did not reflect how the tribunal reached that sum, and no indication was given as to how the total sum had been allocated between the assets and the lost profits. The tribunal deducted from the total sum the amount that the Government was entitled in its counterclaims for the certain liabilities of Aminoil after the Government took over the enterprise, as well as unpaid installments of royalties and taxes.³¹⁰⁵ The tribunal adjusted the resulting amount of compensation to account for inflation. The rate of inflation was fixed by the tribunal at 10%, determined by reference to the price of refined petroleum products on the American market.³¹⁰⁶ Thus, the compensation was established as of the date of the nationalization decree (1977), and the relevant values were then adjusted to the date of the award (1982).

Sir Gerald Fitzmaurice, a member of the tribunal, in his separate opinion, disagreed with the majority as to the principle of interpretation of the stabilization clauses.³¹⁰⁷ Fitzmaurice noted that the question in the case was not that of the right to nationalize in abstracto, “but of the right to nationalise in the face of a contractual undertaking not to do so, if that exists: or more accurately, in terms of the present case, to nationalise where this involves terminating a concession before its time in spite of a provision to the contrary.”³¹⁰⁸ In his view, there was absolutely nothing in the stabilization clauses to warrant the view that they were intended to be confined to the case of confiscatory measures only, since those clauses were not really concerned with confiscation at all, in the direct senses, but concerned with is any measure terminating concession before its time.³¹⁰⁹ He also considered that it was an illusion to suppose that monetary compensation alone could remove the confiscatory element from a take-over, whether called nationalization or something else. He stated that “Nationalisation, or any other form of take-over, is necessarily confiscatory in the sense that, irrespective of the wishes of the legal owner, it dispossesses him of his property and transfers it elsewhere. Nationalisations may be lawful or unlawful, but the test can never be whether they are confiscatory or not: because by virtue of their inherent character, they always are.”³¹¹⁰ As to the finding of the majority that the concession changed over the years by reason of the conduct of the parties relative to it and, as a result, the stabilization clauses had, by 1977, lost their former absolute character, Fitzmaurice stated that, whatever diminution of force the concession suffered it was not a diminution of force that touched the stabilization clauses since the parties never agreed to any change that would enable the Government to terminate

³¹⁰⁴ Ibid., at 1041 para.178(1)

³¹⁰⁵ Ibid., at 1041 para.176

³¹⁰⁶ Ibid., at 1040 para. 171 and 1042 para.178 (5)

³¹⁰⁷ Ibid., at 1049 para. 19

³¹⁰⁸ Ibid., at 1051 para. 22 (b)

³¹⁰⁹ Ibid., at 1051 para. 24

³¹¹⁰ Ibid., at 1052 para. 26

the concession unilaterally.³¹¹¹ Thus, in a dissent of “considerable persuasive force”³¹¹², Fitzmaurice concluded that “although the nationalisation of Aminoil's undertaking may otherwise have been perfectly lawful, considered simply in its aspect of an act of the State, it was nevertheless irreconcilable with the stabilisation clauses of a Concession that was still in force at the moment of the take-over.”³¹¹³

However, Fitzmaurice was in entire agreement with the operational part of the award, which was unanimous, although under his interpretation of the stabilization clauses, the nationalization was unlawful due to Kuwait's violation of the concession itself, since according to the principle underlying Article 26 of the Vienna Convention on the Law of Treaties, treaties and, all agreements governed by international law are binding upon the parties and must be performed by them in good faith.³¹¹⁴ Since his dissent on this point did not affect his concurrence in the final sum awarded to Aminoil, it can be argued that, in both cases of lawful and unlawful expropriation, the compensation due to Aminoil would have comprised the component of lost profits and would have resulted in the same amount. Although, the tribunal adopted a distinction between lawful and an unlawful nationalization to guide its determination of the applicable standards of compensation, the tribunal did not refer to the Chorzow Factory case in the sense that its precedent precluded the investor to claim lost profits where the nationalization is lawful, and the tribunal seems to have incorporated elements that effectively recognized for loss of profits to reflect the parties' “legitimate expectations”, even though the nationalization was found by the majority to be lawful.³¹¹⁵ However, since the award deals, in a cursory fashion, with the evidence supplied by accountants and other experts on the various methods of valuation and calculation, and states certain figures without explaining how those figure were arrived at and how they were related to relevant circumstances such as the period of time, value of assets, price of oil, costs of production and so forth, it is considered as an instance representing the phenomenon of “splitting the difference” between the parties in the context of international arbitration.³¹¹⁶

In the ICSID case of Southern Pacific Properties (SPP) v The Arab Republic of Egypt, the lawfulness of the expropriation arguably affected the amount of compensation due to the investor in the context of worsening business conditions after the date of expropriation. The dispute arose from the agreements concluded in 1974 concerning the development of a tourist village on the Pyramid Oasis. Under the agreements, the parties undertook to incorporate an Egyptian joint venture company for the project. Subsequently, parliamentary opposition to the Pyramids Oasis project developed and culminated in a series of decrees in 1978 that had the effect of cancelling the project. The ICSID tribunal found that the decision to cancel the project constituted a lawful exercise of the right of eminent domain for a public purpose,

³¹¹¹ Ibid., at 1053 para. 28-29

³¹¹² Mann, F. A., *The Aminoil Arbitration*, British Yearbook of International Law, 54-1 (1983), at 213

³¹¹³ Ad-Hoc-Award, *Kuwait v. The American Independent Oil Company (AMINOIL)*, International Legal Materials, 21 (1982), at 1053 para. 30

³¹¹⁴ Mann, F. A., *The Aminoil Arbitration*, British Yearbook of International Law, 54-1 (1983), at 221

³¹¹⁵ Hunter, Martin & Anthony Sinclair, *Aminoil Revisited: Reflections on a Story of Changing Circumstances*, in Todd Weiler (ed.), *International Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law*, Cameron May, 2005, at 366

³¹¹⁶ Mann, F. A., *The Aminoil Arbitration*, British Yearbook of International Law, 54-1 (1983), at 213-214: “The general impression conveyed by the award is that, as so often in arbitrations, strictly legal considerations may have been allowed to be pushed aside for the sake of achieving unanimity among the arbitrators and giving something to both parties.”

namely the preservation and protection of antiquities in the area.³¹¹⁷ However, the evidence showed that no adequate offer of compensation was ever made.³¹¹⁸ The claimants argued that the measure of compensation for taking of an ongoing enterprise should be equal to the value of the enterprise at the time of the taking, and that such value depends on the revenues that the enterprise would have generated had the taking not occurred. In quantifying this value, the claimants relied primarily on the DCF method.³¹¹⁹ The tribunal considered inappropriate to use the DCF method for determining the fair compensation because the project was in its infancy and there was very little history on which to base projected revenues. The tribunal, referring to the Chorzow decision, rejected the DCF method, which would result in awarding “possible but contingent and indeterminate damage” in contravention to the settled rules on international responsibility of states. As a second ground for rejection, the tribunal considered that the DCF method would award *lucrum cessans* on the assumption that lot sales would have continued through the year 1995, although the relevant areas were registered in 1979 under the UNESCO Convention and lot sales would have been illegal under both international law and Egyptian law, so that any profits that might have resulted from such activities from 1979 forward were consequently non-compensable.³¹²⁰

The tribunal awarded to the claimants their alternative claim for out-of pocket expenses plus an amount to compensate the claimants for “the loss of the opportunity to make a commercial success of the project”. The tribunal determined that the out-of pocket expenses consisted of (i) capital contributions and loans made by the claimant to the joint venture, (ii) the development costs, which became irrecoverable losses because these expenses were not reimbursed by the joint venture company or by the future profits due to the cancellation of the project, and (iii) post cancellation costs for legal and audit work which was relevant or useful to the present ICSID proceedings.³¹²¹ As to the claim for damages for loss of opportunity of making a commercial success of the project, the tribunal, while admitting that this determination necessarily involved an element of subjectivism and uncertainty, held that the fact that damages cannot be assessed with certainty is no reason not to award damages when a loss has been incurred. The tribunal was convinced that at the time of project cancellation the value of the claimants’ investment exceeded the out-of-pocket expenses. The tribunal determined the relevant amount on the basis the actual sales made by the joint venture company during the brief period in which the project was in operation. The tribunal used those actual sales to determine the minimum value of the loss of commercial opportunity, and calculated the difference between the claimants’ expenditures and the portion of imputed revenues corresponding to their 60% shareholding in the joint venture company. The tribunal awarded that difference as the opportunity of making a commercial success of the project since the value of the claimants’ investment in 1978 when the project was cancelled exceeded their out-of-pocket expenses.³¹²²

³¹¹⁷ Southern Pacific Properties (Middle East) Limited and Southern Pacific Properties Limited v. The Arab Republic of Egypt, Award of 20 May 1992 in case no. ARB/84/3, Yearbook Commercial Arbitration, (1994), at 73

³¹¹⁸ Ibid., at 74; In the tribunal’s view, the offer of an amount, which was substantially lower than the loss suffered by the claimants and conditioned on the claimant’s willingness to proceed as a minority shareholder with an entirely new and different project, did not constitute a fair compensation.

³¹¹⁹ Ibid., at 79

³¹²⁰ Ibid., at 80

³¹²¹ Ibid., at 81

³¹²² Ibid., at 84; The tribunal also awarded simple interest at the rate of 5%, as prescribed by Egyptian law, applicable from the date on which the dispossession effectively took place. However, since 1978 the US dollar

The compensation of the loss of the opportunity to make a commercial success of the project was based on the same data that were considered insufficient for the DCF method. The tribunal calculated the value of loss commercial opportunity by estimating the revenue and deducting the relevant expenditures, which is similar to the calculation of future profits, the difference being that the tribunal did not use projections for the future, but used figures of sales already made by the time of project cancellation. In this regard, in relation to the argument of the defendant that the reclassification of the land on the Pyramids Plateau was a lawful and mitigating factor in the amount of compensation, the tribunal explained that this factor was already taken into consideration in the tribunal's decision not to award compensation based on profits that might have accrued to the claimants after the date on which areas on the Plateau were registered with the UNESCO. Similarly, in relation to the argument of the defendant that the project was located in an area where the claimants should have known there was a risk that antiquities would be discovered, the tribunal implied that the claimants assumed the said risk, materialization of which eventually deprived the claimants of their compensation on profits that might have been earned after the relevant areas were registered with UNESCO.³¹²³

It can be argued that, had the tribunal found the expropriation unlawful, the risk of subsequent events, which led to a decrease in the value of the undertaking after the expropriation, could have shifted to the defendant under the Chorzow standard. In such a case, the claimant could have been awarded compensation on profits that might have been earned, even after the relevant areas were registered with UNESCO, since the first alternative of valuation as of the date of expropriation under the Chorzow standard would prevent the state from paying a lower compensation, even if the investment would have lost value in the absence of the unlawful expropriation, in view of the fact that expropriation prevented the investor from exercising the option of selling its investment at arm's length. However, the negative subsequent events that affected the value of the investment after an unlawful expropriation may still be taken into account by the decision maker, when the fair market value is the basis of compensation, since the effect of such events should be reflected to the amount of compensation, to the extent that the market would have absorbed, by the time of unlawful expropriation, an expectation as to those events, which then becomes relevant to the determination of the value a willing buyer would normally assign to the undertaking, after taking into account the circumstances in which it would operate in the future.

It is observed that the approach of many tribunals is based on the consideration that, when the investor is granted an exclusive license for a long period, the host state gains by having its resources developed for the benefit of the nation and its citizens, while the exclusive licensee

had undergone significant devaluation. The tribunal decided that for the compensation to be fair, the award of claimants' out-of-pocket expenses should be adjusted upward to account for this devaluation, in order to give the claimants the same purchasing power as they had in 1978. The Tribunal noted that if it had applied a "commercial" rate for the award of interest, this adjustment would not have been necessary, as commercial rates of interest included adjustment for inflation and thus devaluation. In making the adjustment, the tribunal used a "deflating factor" of 2.2074, derived from the data of the International Monetary Fund and computed on the basis of the US Consumer Price Index. The tribunal limited this adjustment to out-of-pocket expenses only and did not adjust its award for the loss of commercial opportunity "because of the nature of that particular cost and the method by which it was determined". It should also be noted that although, in total, the tribunal awarded to the claimants the sum of US\$ 27,661,000, the parties reached an amicable settlement of their dispute under which Egypt paid the claimants US\$ 17.5 million. Ibid., at 104

³¹²³ Ibid., at 90

gains by a receiving a fair return on its investment as well as making a normal operating profit.³¹²⁴ This approach may lead to a balancing exercise between the interests of the parties in order to give effect to their reasonable expectations by ensuring that neither party exploits the other. In that exercise, the decision maker dealing with state party disputes may utilize the established rules of international law in the determination of the amount of compensation due to the investor, as described above. When only a small fraction of the anticipated investment for the benefit of the state and its citizens had been made by the licensee, the claims of the investors for lost profits may be rejected for the lack of certainty of loss thereby avoiding a situation, which might contain an element of exploitation on the part of the investor, who wishes to make a substantial profit without having to make the investment that was originally contemplated. On the other hand, the risk allocation implied by the Chorzow standards prevents the exploitation of the economic windfall on the part of the states that have illegally imposed measures on investments, whose business conditions turned out to be better than expected.

However, regardless of the distinction between lawful and unlawful expropriations and its implications as to the recoverable amount of damages, the consideration of the above interests in the state party disputes may still reflect differences with regard to the evaluation of recoverable damages, as opposed to situation in the private contracts, in such cases that the compensation may be due to the investor for the reason that the contract between the state and the investor was breached, which in itself leads to the application of principle of full compensation, with its components of *damnum emergens* and *lucrum cessans*. The effect of circumstances surrounding the breach of the state party may require an *ex post* balancing exercise between the interests of the parties by the decision maker in order to ensure that neither party exploits the other.

In the case of *Himpurna v. PLN*, Himpurna entered into a contract with the Indonesian state electricity corporation, PLN, to explore and develop geothermal resources in Indonesia, including building power plants in the country and selling the power generated to PLN. Pursuant to the Energy Sales Contract, PLN was obligated to purchase the electricity produced from the plants for a period of thirty years and to pay for it in U.S. dollars. This was a "take-or-pay" contract, under which PLN was obligated to make payments for the electricity whether or not it took immediate delivery. In 1997 and 1998, three Presidential Decrees were issued in the context of the Asian financial crisis. The Decrees meant that PLN could not perform its contractual obligations and resulted in the suspension of Himpurna's investments, since PLN did not need the power it had agreed to purchase. As PLN failed to purchase the energy Himpurna generated, Himpurna submitted a request for arbitration, claiming that PLN breached the Energy Sales Contract. The *ad hoc* arbitral tribunal found that PLN breached the contract by preventing Himpurna from completing the development of additional units and by failing to pay invoices and issue standby letters of credit.³¹²⁵ The tribunal also concluded that the parties' relationship was beyond repair, due to PLN's fundamental breach, and declared, by its award, the contract to be terminated with immediate effect as between the parties.³¹²⁶

³¹²⁴ Hunter, Martin & Anthony Sinclair, *Aminoil Revisited: Reflections on a Story of Changing Circumstances*, in Todd Weiler (ed.), *International Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law*, Cameron May, 2005, at 368

³¹²⁵ *Ad hoc (UNCITRAL) Case, Himpurna California Energy Ltd (Bermuda) v. PT. (Persero) Perusahaan Listrik Negara (Indonesia)*, Final Award, 4 May 1999, at para. 289, 370

³¹²⁶ *Ibid.*, at para. 437

The contract provided that it shall be governed by the laws and regulations of the Republic of Indonesia, and that the tribunal need not be bound by strict rules of law where they consider the application thereof to particular matters to be inconsistent with the spirit of the contract and the underlying intent of the parties.³¹²⁷ The tribunal also noted that the parties' submissions evidenced a tacit common position as to the permissibility of references to international precedents.³¹²⁸ Himpurna claimed both *damnum emergens*, which consisted of capital invested and expended plus interest, and *lucrum cessans*, which assigned a present value to the expected future revenue stream; the nominal amounts were decreased by applying two discount rates (one reflecting the time value of money and the other a risk premium).³¹²⁹ The tribunal first considered that, under the Indonesian Civil Code, damages may include the loss which the creditor has suffered and the profit he has been made to forego. According to the tribunal, it was impossible to establish damages as a matter of scientific certainty, but this should not impede the course of justice. The tribunal stated that "Approximations are inevitable. Moreover, considerations of fairness enter into the picture, to be assessed - inevitably - by reference to particular circumstances. The fact that the Arbitral Tribunal is influenced in this respect by equitable factors does not mean that it shirks the discipline of deciding on the basis of legal obligations." In this regard, the tribunal noted that the Sapphire award was based on "general principles of law" but nevertheless decided *ex aequo et bono* when assessing damages, and cited the following statement from the Aminoil award: "It is well known that any estimate in purely monetary terms of amounts intended to express the value of an asset, of an undertaking, of a contract, or of services rendered, must take equitable principles into account." According to the tribunal, "The Sapphire and Aminoil awards were on the firm footing of significant international precedents."³¹³⁰

With respect to the evaluation of financial data, the tribunal first stated that "When a DCF method for evaluating damages in the context of a contractual breach is followed, any comparisons with precedents involving the evaluation of expropriated business ventures must be made with great care. In the latter situation, there is generally no basis to apply the contractual reliance damages (*damnum emergens*), but only the expectancy damages (*lucrum cessans*). An undertaking has been expropriated; the prejudice suffered by its former owner is simply the worth of the venture as a going concern, which is crystallized in an analysis that discounts the future revenue stream of the enterprise to establish its present value."³¹³¹ The tribunal considered that, in those cases, had there been no expropriation, past investments would have been recovered through subsequent revenues, and since those revenues are fully accounted for in the DCF going-concern evaluation, an award of lost investment as well would be an unacceptable double recovery. The tribunal stated that, in contractual cases, it is usual that claimants seek recoupment of their entire investment as a discrete element of compensation. According to the tribunal, while claimants are on solid ground when they ask to be reimbursed monies they have actually spent in reliance on the contract, the recovery of lost future profits is less certain.³¹³² In this context, the tribunal was of the opinion that the quantification of lost profits must result in a lower amount to avoid double counting because future net cash flow generally includes all the amortization of investment there will ever be.

³¹²⁷ *Ibid.*, at para. 90-92

³¹²⁸ *Ibid.*, at para. 98

³¹²⁹ *Ibid.*, at para. 438

³¹³⁰ *Ibid.*, at para. 441

³¹³¹ *Ibid.*, at para. 444

³¹³² *Ibid.*, at para. 445

The tribunal considered that if the DCF method is applied in a contractual scenario to measure nothing but net cash flows, there is no room for recovery of wasted costs. Thus, the tribunal concluded that when the victim of a breach of contract seeks recovery of sunken costs, confident that it is entitled to its *damnum*, it may seek lost profits only with the proviso that its computations reduce future net cash flows by allowing a proper measure of amortization. The tribunal was satisfied that what the claimant presented as the “initial project value” reflected the alleged value of future cash flows, discounted to the date of valuation, which indeed deducted the alleged value, at the same date, of past investments.³¹³³

With respect to *damnum emergens*, the tribunal stated that Himpurna was entitled to reimbursement for monies that Himpurna could prove that it spent in reliance on the contract. The tribunal considered that if PLN and Himpurna had been engaged in a joint venture on behalf of which Himpurna was incurring costs, or if there had been an agreement that Himpurna had some right to recover costs from future earnings, one would reasonably expect that there would have been an agreed system of approval and verification of costs.³¹³⁴ However, in the case, Himpurna’s investment was made at its entire risk; “it could incur costs in accordance with its own assessment of its obligations, of efficient operations, and of the prospects of recovering costs through future earnings.” The tribunal was of the opinion that Himpurna made its expenditures in reliance on the contract, and had every incentive to keep those costs low, because all savings would be to its own undiluted benefit.³¹³⁵ Thus, the tribunal held that Himpurna needed “only to show that it has made expenditures; it [was] for PLN to show that they have no reasonable connection with the pursuit of contract objectives”.³¹³⁶ However, PLN broadly failed to do so, albeit with some exceptions. To establish the present value of these sunken costs, the tribunal adopted the multiplier used by PLN’s financial expert, even if that number was unlikely to be rigorously accurate, in the absence of information to allow the tribunal to make a re-computation, to reflect the present value. Applying this multiplier, the tribunal determined that the recoverable *damnum emergens* was US\$ 273,757,306.³¹³⁷

As to the claim for *lucrum cessans*, the tribunal referred to the applicable law, noting that “Article 1246 of the Indonesian Civil Code - echoing its precursor, Article 1149 of the French Code civil – provides for the recovery of lost profit... But the Code goes on to set out limiting factors which, again, are quite familiar. Article 1247 (congruent with Article 1152 of the Code civil) restricts recovery to damages foreseeable at the time of contracting and Article 1248 (congruent with Article 1284 of the Code civil) requires that damages be the “immediate and direct result of the breach”.³¹³⁸ The tribunal also noted that in the numerous legal systems where these, or similar, rules prevail, the effect of the limiting factors can be seen as a test of reasonableness and equity.³¹³⁹ While the expert evidence of PLN attempted to persuade the tribunal to take into account that awarding lost profits in very large sums of damages may be a heavy burden when the sum claimed is totally out of proportion to the capital invested, the

³¹³³ Ibid., at para. 446

³¹³⁴ Ibid., at para. 463

³¹³⁵ Ibid., at para. 464

³¹³⁶ Ibid., at para. 473

³¹³⁷ Ibid., at para. 491-493

³¹³⁸ Ibid., at para. 496

³¹³⁹ Ibid., at para. 497

tribunal maintained that lost profits flow directly from the contractual allocation of risks including the commercial risks of market share and price fluctuations, currency and inflation risks, and the risks of governmental interference, and when these risks are extant, the notion of some form of proportionality in the sense of a normal return on invested capital may make sense, but the contract in this case explicitly excluded each of these risks.³¹⁴⁰

According to the tribunal, the significant controversies with respect to lost profits related to the quantities that should be deemed to be covered by PLN's take-or-pay obligations, and the discount rate that should be applied to the future income stream. The tribunal considered that, to the extent the claim was based on production volumes that appeared certain, the issue of proportionality to invested capital did not arise, since the lost profit flowed directly from the contractual allocation of risk.³¹⁴¹ Even so, the tribunal agreed with the figure proposed by PLN's expert that there were only 130 MW of proven reserves, as opposed to the claimant's assumption of a sustainable electricity generation capacity of 245 MW for a period of 30 years. According to the tribunal, it was possible to accept the evidence of both experts as the exercise was one of estimation, where each analysis may be plausible and well founded in its own terms. The tribunal preferred the lowest figures put forward by PLN's expert, given all the circumstances of this case in an attempt to be as lenient with PLN as one possibly could³¹⁴², while still respecting the imperatives of contractual reliability, and accepting that evaluations of quantum should have an equitable component. In this regard, the tribunal stated that "while declining to disregard or amend the Contract on the grounds of changed circumstances...., the Arbitral Tribunal as a matter of equity nevertheless gives great weight to those circumstances when making the allowance for lost profits."³¹⁴³

Moreover, the tribunal noted that Himpurna's estimate of damages would lead to recovery beyond a return on investments actually made, since it would justify hundreds of millions of dollars in damages because PLN thwarted a contractual right to make future investments which PLN was bound to remunerate at prices ensuring substantial profits.³¹⁴⁴ Although admitting that "damages for the loss of a bargain may in principle be granted even when the victim of a breach has not yet incurred significant costs", the tribunal ultimately refused to grant profits on investments that had not been made at the date of breach. The tribunal compared the circumstances of the case to those of *Sapphire* case, where the sole arbitrator, fixing the quantum "ex aequo et bono by considering all the circumstances", awarded the claimant a lump sum for its loss of chance due to the defendant's breach of oil concession agreement during an early stage of exploration and before any drilling.³¹⁴⁵ The tribunal considered that, in *Sapphire*, if the sole arbitrator had not allowed the recovery for loss of chance, he would in fact have tolerated a breach with impunity but, in the present case,

³¹⁴⁰ Ibid., at para. 497-498

³¹⁴¹ Ibid., at para. 501

³¹⁴² In this regard, the tribunal openly expressed the profound impression made by the "powerful opening statement" of the lead counsel for PLN, who poignantly evoked the economic context in which this dispute takes place, and emphasized such facts that, in 1998 to 1999, the Indonesian economy contracted by 15 per cent, resulting in more than 5 million workers losing their jobs, the rupiah lost more than 80 per cent of its value and, out of a population of 200 million, the number of seriously poor people in Indonesia was projected to reach 130 million. Ibid., at para. 386

³¹⁴³ Ibid., at para. 517

³¹⁴⁴ Ibid., at para. 519

³¹⁴⁵ Ibid., at para. 521

Himpurna sought to be made whole for all of its expenditures and to recoup a return thereon calculated over 30 years, before even getting to the issue of loss of bargain on investments not yet made at the date of the breach. Moreover, the tribunal considered that whereas in *Sapphire* the foreign investor had entered into the agreement on the basis of producing oil for export on the world markets, in the present case it was explicitly understood that the only purchaser for the energy produced would be PLN. According to the tribunal, it was unacceptable to assess lost profit as though Himpurna had an unfettered right to create ever-increasing losses for Indonesia and its people by generating energy without any regard to whether or not PLN had any use for it.³¹⁴⁶ In this regard, the tribunal relied on the doctrine of “abuse of right”. Thus, even if such an unfettered right may be said to derive from explicit contractual terms, the tribunal held that the principle of *pacta sunt servanda* found its limits in this case in the concept of abuse of right.³¹⁴⁷

The tribunal applied the doctrine of abuse of right as an element of overriding substantive law proper to the international arbitral process. In the tribunal’s view, this law is not an elaborate body of law, limited to a few universal principles, but this fact does not detract from their value when used to ensure the legitimacy of the international arbitral process. The tribunal observed that the doctrine of abuse of rights has been applied notably when arbitral tribunals have upheld the principle of the autonomy of the arbitration or refused to accept that a state invoked its internal law as an impediment to its consent to arbitration.³¹⁴⁸ Then, the tribunal expressed its view that if the general principle of abuse of rights may be invoked in favor of the foreign investor so as to avoid the result that its legitimate expectations are frustrated by unworthy maneuvers, so too, may it be invoked in certain circumstances against claims for profit which would tend to impoverish the host state.³¹⁴⁹ The tribunal believed that this was a case “where the doctrine of abuse of right must be applied in favour of PLN to prevent the Claimant’s undoubtedly legitimate right from being extended beyond tolerable norms, on the grounds that it would be intolerable in the present case to uphold claims for lost profits from investment not yet incurred.”³¹⁵⁰

The tribunal noted that the energy supplied under the contract was not exportable, and to oblige PLN, the only purchaser, to compensate for massive future investments would be perverse.³¹⁵¹ The tribunal also considered the nature of breach, where the purpose and consequence of the acts that led to liability were not to replace the claimant in its enjoyment of the benefits of an existing or prospective revenue stream and there was no realistic prospect of PLN intervening in the immediate wake of the award to implement the investment program envisaged under the contract.³¹⁵² Although admitting that the primary goal of monetary compensation in international arbitration is to make the victim whole rather than to prevent unjust enrichment, the tribunal concluded that the absence of the prospect of unjust enrichment has a moderating effect on a claim for lost profits.³¹⁵³ Thus the arbitral tribunal

³¹⁴⁶ *Ibid.*, at para. 522

³¹⁴⁷ *Ibid.*, at para. 523

³¹⁴⁸ *Ibid.*, at para. 528

³¹⁴⁹ *Ibid.*, at para. 530

³¹⁵⁰ *Ibid.*, at para. 534

³¹⁵¹ *Ibid.*, at para. 535

³¹⁵² *Ibid.*, at para. 540

³¹⁵³ *Ibid.*, at para. 546

stated that “To seek to apply the [Energy Sales Contract] so as to permit the Claimant to reap pure profit by reference to hypothetical future initiatives in pursuit of an agreement which has become an instrument of oppression would be like stepping on the shoulders of a drowning man. The Arbitral Tribunal finds that it would be insufferable, and therefore an abuse of right”.³¹⁵⁴

The tribunal thereby awarded a percentage of lost profits that was proportionate to the investment the claimant had actually made. In order to calculate the recoverable lost profits, the tribunal compared the recoverable *damnum emergens* it had accepted as having been incurred by the claimant (US\$ 273,757,306) with the amount the claimant had put forward as the present value of its projected costs over the life of the contract if it had to be performed (US\$ 748,564,000). The tribunal limited the recoverable profits to that proportion, i.e. 36% of the total claim of lost profits.³¹⁵⁵ The tribunal then considered the issue of determining the present value of the future net income. The claimant had applied a discount rate of 8.5% to the projected revenue stream and to the costs associated with the revenues. The tribunal took into account not only the riskier nature of a 30-year venture in Indonesia than in more mature economies, but also its adoption of reservoir estimates substantially inferior to the ones proposed by PLN's own experts and its refusal to offer compensation on account of profits on investments not yet made.³¹⁵⁶ Accordingly, the tribunal adjusted the discount rate, in their equitable assessment of the evidence, and, in the circumstances of the case, resolving all doubts in favour of PLN, and found the appropriate rate to be 19%.³¹⁵⁷ As a result, the tribunal took 36% of the claimant's after-tax net cash flow projections, and discounted it to the present value at the rate of 19%, with the resulting amount awarded being US\$ 117,244,000 as *lucrum cessans*.³¹⁵⁸ Thus, the tribunal granted Himpurna all of the reliance damages (sunken costs, or *damnum emergens*) that it could prove, but adopted a rigorously critical approach in evaluating Himpurna's evidence, and allowed it to recover for its lost profit claim (expectance damages, or *lucrum cessans*) less than 10% of the amount it put forward.³¹⁵⁹

The approach of the tribunal in Himpurna award is criticized. One of the arbitrators in the tribunal, while not dissenting from the result as far as it went, appended a “statement” to the award: “The imposition of a concept described as 'abuse of rights' in the absence of findings of malicious intent or lack of good faith on the part of the Claimant to further reduce the entitlement to damages is in my opinion an inappropriate and unwarranted penalising of the Claimant.”³¹⁶⁰ It is argued that it is not, as the tribunal stated, a general principle of private international law that precludes the awarding of lost profits whenever awarding such profits would cause a severe financial hardship to the party that has breached the contract, and if the circumstances radically change between the time of contracting and the completion of the contract, concepts such as *force majeure* and hardship would apply to the dispute either

³¹⁵⁴ Ibid., at para. 547

³¹⁵⁵ Ibid., at para. 551

³¹⁵⁶ Ibid., at paras. 562, 565, 571

³¹⁵⁷ Ibid., at para. 575

³¹⁵⁸ Ibid., at para. 581

³¹⁵⁹ Ibid., at para. 587

³¹⁶⁰ Cited by Petrova, Irina, “Stepping on the Shoulders of a Drowning Man” The Doctrine of Abuse of Right as a Tool for Reducing Damages for Lost Profits: Troubling Lessons from the Patuha and Himpurna Arbitrations, *Georgetown Journal of International Law*, 35 (2004), at 462-463

pursuant to the parties' contract or as part of the applicable governing substantive law, rather than as a rule of private international law, the substance of which is obligatory in international arbitration.³¹⁶¹ It is pointed out that the reduction in the amount of damages awarded to Himpurna demonstrates the danger inherent in the abuse of right reasoning, since a broad formulation of the doctrine allows for a great deal of discretion that may lead to analytically strained results and undermine notions of legal certainty. In this regard, it is suggested that the factors that may be used in determining whether an abusive exercise of a right has occurred should be limited to injurious motive and improper purpose.³¹⁶²

The award in Himpurna case demonstrates the balancing exercise by an arbitral tribunal between the interests of the parties in a state party dispute in assessing the amount of damages. The tribunal in Himpurna case took into account that the government did not act opportunistically in breaching the contract and government would not be able to make full use of the investment due to deterioration of the macroeconomic value of the project as of the date of award. Those were also taken into consideration in the decision of the ICSID tribunal in the case of *SPP v the Arab Republic of Egypt*, which was referred to in Himpurna award in relation to its observation that “the recovery is moderate where the purpose and consequence of the acts that led to liability were not to replace the claimant in its enjoyment of the benefit of an existing or prospective revenue stream”.³¹⁶³ Thus, having determined that the breach was not opportunistic and considering the severe effect of the crisis on Indonesia, the tribunal strived to protect the interests of Indonesia as much as possible by means of the flexibility afforded to it in the determination of the quantum of damages and in awarding *lucrum cessans*. However, when it came to the issue of lost profits for the investment that had not occurred by the time of breach, the tribunal was “struck by the fact that the Claimant was seeking to turn the [Energy Sales Contract] into an astonishing bargain in circumstances when performance of the Contract would be ruinous to the Respondent. (A US\$ 2.3 billion return - including the unpaid invoices - would represent a 630% profit on a US\$ 315 million investment)”.³¹⁶⁴ Thus, the tribunal had differed in its approach from the “international precedents” by resorting to the doctrine of abuse of rights in regard to loss of future profits from an investment not yet incurred in a case where the defendant did not seek actively to dispossess the claimant of valuable contractual rights, but it had suffered helplessly from a precipitate deterioration in the macroeconomic value of a project with respect to which it had accepted the entire market risk.³¹⁶⁵

The reference to the doctrine of abuse of rights is open to criticism for the absence of proof showing an ill motive or explicit abuse by the claimant in seeking damages for the loss of opportunity to make profits, as such proof would be required under many national legal systems. For example, in the case of *Karaha Bodas Co. (KBC) v. Perusahaan Pertambangan Minyak Dan Gas Bumi Negara (Pertamina) and PT. PLN*, which involved another power project subsequently suspended by Indonesia because of the financial crisis in the same

³¹⁶¹ Gotanda, John Y., *Recovering Lost Profits in International Disputes*, *Georgetown Journal of International Law*, 36 (Fall 2004), at 106

³¹⁶² Petrova, Irina, “Stepping on the Shoulders of a Drowning Man” *The Doctrine of Abuse of Right as a Tool for Reducing Damages for Lost Profits: Troubling Lessons from the Patuha and Himpurna Arbitrations*, *Georgetown Journal of International Law*, 35 (2004), at 481-482

³¹⁶³ *Ad hoc (UNCITRAL) Case, Himpurna California Energy Ltd (Bermuda) v. PT. (Persero) Perusahaan Listrik Negara (Indonesia)*, Final Award, 4 May 1999, para. 546

³¹⁶⁴ *Ibid.*, at para. 522

³¹⁶⁵ *Ibid.*, at para. 536

period, the tribunal held that Pertamina and PLN had breached the agreements with KBC, and were 'condemned' to pay US\$111.1 million for 'lost expenditures' and US\$150 million for 'loss of profits' for an investment that had not been completed. The doctrine of abuse of rights had not been discussed in the arbitration, but it was raised in the enforcement proceedings by Pertamina. Pertamina challenged enforcement of the award in the US federal district court on the ground that "enforcement of the damages Award would violate the public policy of the United States". Pertamina argued that "the Award violated the international abuse of rights doctrine and punished Pertamina for obeying the Indonesian government's decree." In the appeal, Pertamina argued that "the Award is contrary to public policy because it violated the international law abuse of rights doctrine and because the district court's decision holds Pertamina liable for complying with Indonesian law."³¹⁶⁶ The US Court of Appeals for the Fifth Circuit held that an action can only violate the abuse of rights doctrine if one of the following three factors is present: (1) the predominant motive for the action is to cause harm; (2) the action is totally unreasonable given the lack of any legitimate interest in the exercise of the right and its exercise harms another; or (3) the right is exercised for a purpose other than that for which it exists. The Court stated that "The abuse of rights doctrine is not established in American law and KBC's actions do not meet the factors required to trigger its application." According to the Court, the evidence in the record did not support Pertamina's argument that enforcing the award would penalize obedience to a governmental decree. The Court noted that the tribunal explained in the award that the relevant contracts between the parties shifted the risk of loss resulting from a government-ordered suspension onto Pertamina and PLN. In this context, the Court considered that Pertamina was challenging the substance of the tribunal's interpretation of the relevant contracts. The Court held that "An arbitration tribunal's contract interpretation does not violate public policy unless it "violates the most basic notions of morality and justice." The Tribunal's interpretation of the [Joint Operation Contract] and [Energy Sales Contract] does not approach this steep threshold."³¹⁶⁷

However, the award of Karaha Bodas is also criticized from the point of view of the economists for being likely excessive, due to its failure to reflect the fair market value, which should lead to Pareto optimal results: "the party initiating the breach will be better off (the Indonesians will not have to pay for unneeded electricity) and the other party (KBC) will not be worse off than if the event had not occurred."³¹⁶⁸ It is pointed out that the project, including all assets and improvements, would revert free of cost to Pertamina at the end of 30 years, and projecting the stream of earnings for 30 years requires some heroic assumptions for a project that has not yet been completed. It is argued that the arbitrators in the case double counted in determining the amounts owed by Pertamina and PLN by awarding the amount of the investment, with no adjustment for the investment that had not been completed, plus the net present value of expected cash flows and, thus the resulting sum, which was 2.5 times the amount of investment that KBC claims to have made, was far above any reasonable estimate of the legitimate fair market value of the uncompleted project.³¹⁶⁹ It is suggested that such excessive awards encourage investment in projects with great political risk, and behavior on the part of the investor to engineer an apparent default in order to reap greater profit by not performing than it would have earned if it performed, while discouraging government takings,

³¹⁶⁶ Karaha Bodas Co v Perusahaan Pertambangan Minyak Dan Gas Bumi Negara 364 F.3d 274 (5th Cir. 2004), at para. 24

³¹⁶⁷ Ibid., at para. 97

³¹⁶⁸ Wells, Louis T., Double Dipping in Arbitration Awards? An Economist Questions Damages Awarded to Karaha Bodas Company in Indonesia, *Arbitration International*, 19-4 (2003), at 474

³¹⁶⁹ Ibid., at 477

or breach of contract, when such actions are in fact efficient and thus desirable.³¹⁷⁰ In the end, it is noted that KBC assets lied idle while the legal wheels turned for the collection of the award from Pertamina's assets in Singapore, Hong Kong, Canada, and the United States, whereas Dieng, a part of Himpurna's former project, was at least generating some electricity.³¹⁷¹

Moreover, it should be noted that the doctrine of abuse of rights as applied by the tribunal in the Himpurna award was distinct from the comparable doctrines that can be found in the national legal systems. The tribunal set aside the arguments of the parties as to the applicability of Indonesian law: both Article 1338 of the Civil Code that all contracts should be performed in good faith and Article 2(1) of the Usury Act of 1938 that a disproportion of obligations may entitle a judge to mitigate the obligations or even to declare the contract void.³¹⁷² The tribunal referred to an autonomous doctrine of abuse of rights, which it found in the arbitral decisions under the influence of the transnational theory of arbitration, and which purported to protect the interests of the foreign investors by preventing the host states from invoking their internal laws as an impediment to their consent to arbitration or their contractual obligations. It is considered as part of "international public policy" that "the states cannot later claim that they could not submit to arbitration due to their own national law."³¹⁷³ The reasoning of the tribunal in the Himpurna award was apparently influenced by the consideration that if such an autonomous doctrine is widely accepted as valid when it is applied to protect the fundamental interests of the investors, without questioning its validity due to its dissimilarities with the comparable doctrines of the national legal systems, it should be equally and validly asserted for the protection of the similarly fundamental interests of the host state, when those are at stake in the particular circumstances of the case.

In the case, the terms of the contract and the doctrines of force majeure or hardship under the applicable law did not allow any limitation of liability for the non-performance of the state party despite the grave macroeconomic consequences of awarding damages on the basis of the parties' initial risk allocation. Moreover, the tribunal observed that the established rules have also proved insufficient to prevent the conflict between the expectations of the parties. The tribunal reached to the limits of ex post balancing exercise between the interests of the parties, as provided by the established rules and the flexibility in the estimates and approximations of the DCF method. The resulting decision, which was considered as being insufficient to protect the interests of the state party, seemed still inconsistent with the order of international commerce in the abstract reasoning of the tribunal, as it would directly disturb the internal order of Indonesia and, indirectly, the peaceful development of the overall order of international commerce. The fundamental question was that which of conflicting expectations is to be declared as reasonable, where the decision could not be logically deduced from the established rules. The tribunal invoked another established rule, the autonomous doctrine of abuse of rights, which so far had a different scope of application, in order to render a decision that serves the same order of actions as the other established rules. The tribunal found that the rule that allowed the claimant to obtain lost opportunity to make profit, counted on by the investor in forming his expectations, was false in the particular circumstances of the case,

³¹⁷⁰ Ibid., at 478

³¹⁷¹ Ibid., at 481

³¹⁷² Ad hoc (UNCITRAL) Case, Himpurna California Energy Ltd (Bermuda) v. PT. (Persero) Perusahaan Listrik Negara (Indonesia), Final Award, 4 May 1999, at para. 526

³¹⁷³ Böckstiegel, Karl-Heinz, *Arbitration and State Enterprises: a Survey on the National and International State of Law and Practice*, Kluwer Law and Taxation Publishers, 1984, at 25

even though it could be widely accepted and universally approved, because the tribunal discovered that in the particular circumstances it clashed with expectations, that could be based on the autonomous doctrine of abuse of rights.

In the end, since, in its consideration, any other decision would not have served to enabling the correspondence of expectations in the order of international commerce, the tribunal eventually modified both rules counted on by the parties. It adopted a preventive approach to ensure the observance of good faith in the exercise of rights. The tribunal mentioned Bin Cheng's articulation of abuse of right as lack of good faith in the exercise of rights, and cited the principle of proscription against abuse of legal forms (*ex re sed non ex nomine*).³¹⁷⁴ Cheng explains that, *ex re sed non ex nomine* is a principle of good faith and, *inter alia*, precludes the form of the law being used to cover the commission of what in fact is an unlawful act.³¹⁷⁵ Under the autonomous doctrine of abuse of rights, this principle represents the prohibition of a state's exercise of its rights to manipulate the regime applicable to legal entities controlled by a state for the purpose of evading its obligations.³¹⁷⁶ Thus, the doctrine, as articulated by Cheng, at least requires an improper purpose in the exercise of the rights.³¹⁷⁷ In this regard, the tribunal merely stated that "The Arbitral Tribunal does not believe that either Party has committed an abuse of right; rather, it wants to ensure that none occurs."³¹⁷⁸

This preventive approach adopted by the tribunal on the basis of its abstract reasoning can be criticized for "opening the door to subjective decision-making", which, in the tribunal's own words, had to be taken seriously. Even so, the tribunal did not consider it decisive, noting that the claimant anticipated a risk of a finding of abuse of rights and argued vehemently against it.³¹⁷⁹ The tribunal stated that "the legal process necessarily depends, to some extent, on the personal convictions of the decision-maker. If this were not so, the common law could hardly accommodate the notion of implied terms, nor could the civil law give effect to the fundamental rule - reflected in Article 1338(3) of the Indonesian Civil Code - that contracts must be performed in good faith."³¹⁸⁰ The tribunal concluded, in the award that, in satisfying the award PLN will be in a position to profit from the costs of investments, and if the Indonesian economy and demand for energy are resurgent, and if the projections put forward by the claimant are revealed to be correct, the outcome of the proceedings may have been favorable to PLN notwithstanding its breach. The tribunal stated that this was actually the premise of the contract as of 1994, "[b]ut the premise succumbed to a bitter wind, and having to deal with the circumstances as it found them, the Arbitral Tribunal sought to alleviate

³¹⁷⁴ Ad hoc (UNCITRAL) Case, *Himpurna California Energy Ltd (Bermuda) v. PT. (Persero) Perusahaan Listrik Negara (Indonesia)*, Final Award, 4 May 1999, at para. 529

³¹⁷⁵ Cheng, Bin, *General Principles of Law as Applied by International Courts and Tribunals*, Cambridge: Grotius Publications, 1987, at 122

³¹⁷⁶ Böckstiegel, Karl-Heinz, *Arbitration and State Enterprises: a Survey on the National and International State of Law and Practice*, Kluwer Law and Taxation Publishers, 1984, at 25, at 45

³¹⁷⁷ Petrova, Irina, "Stepping on the Shoulders of a Drowning Man" *The Doctrine of Abuse of Right as a Tool for Reducing Damages for Lost Profits: Troubling Lessons from the Patuha and Himpurna Arbitrations*, *Georgetown Journal of International Law*, 35 (2004), at 476-477

³¹⁷⁸ Ad hoc (UNCITRAL) Case, *Himpurna California Energy Ltd (Bermuda) v. PT. (Persero) Perusahaan Listrik Negara (Indonesia)*, Final Award, 4 May 1999, at para. 532

³¹⁷⁹ *Ibid.*

³¹⁸⁰ *Ibid.*, at para. 533

PLN's burden as much as possible while respecting the clear contractual entitlements of the Claimant under an agreement which by its terms left very little to chance".³¹⁸¹

The tribunal's final decision reached by the application of the autonomous doctrine of abuse of rights, in order to alleviate the burden of the state party, may seem fair in the particular circumstances of the case. The doctrine of abuse of right was invoked, because the claimant had a contractual right to make future investments under terms, which would have been ruinous to Indonesia, and the enforcement of that executory part of the contract would enable the claimant to pursue a program only to collect damages not yet incurred.³¹⁸² However, the decision may still be criticized for its failure to be more explicit and to elaborate on its theory, which may be called "anticipatory abuse of rights". Perhaps for that reason, this unique theory has not typically been adopted by the tribunals in the context of international investment disputes, and it is considered as "a potentially awkward precedent".³¹⁸³

On the other hand, the tribunal's approach of balancing exercise between those interests by utilizing the flexibility afforded by the articulated and established rules is apparent in the ICSID case of *CMS Gas Transmission Company v The Argentine Republic*. CMS Gas, a US company, purchased approximately 30% share of TGN, an Argentinean gas transportation company.³¹⁸⁴ Under the regime established by the laws and decrees and by the license granted to TGN in the context of Argentine's privatization of its natural gas transmission and distribution companies, tariffs were to be calculated in US dollars, conversion to pesos to be effected at the time of billing and tariffs adjusted every six months in accordance with the US Producer Price Index (US PPI).³¹⁸⁵ Towards the end of the 1990s, a serious economic crisis began to unfold in Argentina. In 2001, the Government passed emergency decrees and laws, under which the right of licensees of public utilities to adjust tariffs according to the US PPI and to calculate tariffs in dollars was terminated. The tariffs were redenominated in pesos at the rate of one peso to one dollar.³¹⁸⁶ CMS argued that the guarantees with regard to the basic rules governing the license constituted essential conditions for CMS's investment, and that it had an acquired right to the application of the agreed tariff.³¹⁸⁷ It was further argued that the measures adopted were all attributable to the Argentine Government and resulted in the violation of all the major investment protections owed to CMS under the Argentina-US Bilateral Investment Treaty (the BIT). CMS requested compensation in the amount of US\$ 261 million, which represented the decreased value of its shares in TGN plus interest and costs. The Government argued that the license, and the legal and regulatory framework governing it, provided only for the right of the licensee to a fair and reasonable tariff and no guarantees were offered in respect of convertibility and currency devaluation, and the risk inherent to the investment in these respects was expressly brought to the attention of the

³¹⁸¹ Ibid., at para. 588-590

³¹⁸² Paulsson, Jan, the Expectation Model, in Yves Derains & Richard H. Kreindler, (eds.), *Evaluation of Damages in International Arbitration*, ICC Publication No. 668, 2006, p. 57, at 72-73

³¹⁸³ Weisburg, Henry, & Christopher Ryan, Means to be Made Whole: Damages in the Context of International Investment Arbitration, in Yves Derains & Richard H. Kreindler, (eds.), *Evaluation of Damages in International Arbitration*, ICC Publication No. 668, 2006, at 178

³¹⁸⁴ *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8, Award of the Tribunal (May 12, 2005), at para. 58

³¹⁸⁵ Ibid., at paras. 57, 138, 144

³¹⁸⁶ Ibid., at para. 65

³¹⁸⁷ Ibid., at para. 87

company.³¹⁸⁸ The ICISD tribunal rejected CMS' claims of expropriation under Article IV and of discriminatory and arbitrary treatment under Article II(2)(b) of the BIT.³¹⁸⁹ On the other hand it ruled that Argentina had "breached its obligations to accord the investor the fair and equitable treatment guaranteed in Article II(2)(a) of the Treaty and to observe the obligations entered into with regard to the investment guaranteed in Article II(2)(c) of the Treaty".³¹⁹⁰

In determining the compensation due in the circumstances, the tribunal first considered that depending on the circumstances, various methods have been used by the tribunals to determine the compensation which should be paid, but the general concept upon which commercial valuation of assets is based is that of "fair market value". The tribunal referred to, in its view, "an internationally recognized definition" which reads as "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy and when both have reasonable knowledge of the relevant facts."³¹⁹¹ However, in the absence of expropriation and guidance in the Treaty as to the appropriate measure of damages or compensation relating to fair and equitable treatment and other breaches of the standards, the tribunal had to exercise its discretion to address the standard of compensation applicable in the circumstances of the dispute.³¹⁹² Exercising its discretion and considering the cumulative nature of the breaches in the case and their effect of long-term losses, the tribunal decided to apply the standard of fair market value, even if it prominently applies to the cases of expropriation.³¹⁹³ The Tribunal selected the DCF method as the most appropriate in the case for the following reasons: (i) the shares of TGN were not publicly traded on a stock exchange or any other public market, (ii) TGN was a going concern, (iii) DCF techniques had been universally adopted, including by numerous tribunals, as an appropriate method for valuating business assets, (iv) there was adequate data to make a rational DCF valuation of TGN, and (v) experts from both sides agreed that the DCF was the proper method in the case for determining losses that had extended through a prolonged period of time.³¹⁹⁴

The tribunal determined that no damages should be considered beyond the initial period of 35 years of the license of TGN, ending in 2027. Although TGN was entitled to an additional ten-

³¹⁸⁸ Ibid., at para. 91

³¹⁸⁹ Ibid., at paras. 263-264, 295

³¹⁹⁰ Ibid., at paras. 281, 303 and sub-para. 1 of the *dispositive*; The Tribunal's finding on Article II(2)(c) was annulled by the ad hoc Committee for failure to state reasons. However, the award as a whole was not affected by this annulment. The tribunal's award of damages was made on the basis of independent findings of breach of Article II(2)(a) and (c) of the BIT, and Article II(2)(c) invoked by CMS did not add anything different to the overall Treaty obligations which the Government must meet. Thus the Committee's finding on Article II(2)(c) did not entail the annulment of the Award as a whole, but entailed only annulment of the provisions of paragraph 1 of the operative part of the award under which the tribunal decided that "[t]he Respondent breached its obligations... to observe the obligations entered into with regard to the investment guaranteed in Article II(2)(c) of the Treaty." CMS Gas Transmission Co. v. Argentine Republic (ICSID Case No. ARB/01/08) Annulment Decision, Sept. 25, 2007, at paras. 97-100

³¹⁹¹ CMS Gas Transmission Company v. The Argentine Republic, ICSID Case No. ARB/01/8, Award of the Tribunal (May 12, 2005), at para. 402 [Footnote reference: International Glossary of Business Valuation Terms, American Society of Appraisers, ASA website, June 6, 2001, p.4]

³¹⁹² Ibid., at para. 409

³¹⁹³ Ibid., at para. 410

³¹⁹⁴ Ibid., at paras. 412-417

year extension of the license, the tribunal considered that the license was very clear about the fact that this right was conditional and subject to a number of steps, both substantive and procedural, which might or might not take place, and it would be impossible to establish at the time of the award whether these conditions might be met. Thus, the tribunal decided to rely on the year 2027 for its determination of damages.³¹⁹⁵ The tribunal noted the challenges associated with the DCF analysis in the case because some of the relevant factors included a large degree of uncertainty. The tribunal had to evaluate “not only what the years 2000 to 2027 would have been like had TGN’s license and regulatory environment remained unchanged, but also to foresee what the future held for TGN under the new (and not completely known) regulatory environment.”³¹⁹⁶ Even so, the tribunal decided that it was still possible, with the appropriate methodology and the use of reasonable alternative sets of hypotheses, to arrive at “rationally justified” figures that would not be “arbitrary or analogous to a shot in the dark”.³¹⁹⁷

The tribunal repeatedly stated in the award that the crisis could not be ignored and it had specific consequences on the question of appropriate remedy.³¹⁹⁸ The tribunal even stated that it “has the greatest sympathy for the plight of the Argentine people under the circumstances and respects its efforts to overcome the situation.”³¹⁹⁹ Although, the tribunal did not accept the applicability of the doctrines of hardship and state of necessity³²⁰⁰, it decided to take into account the crisis as a matter of fact, and stated that “facts of course do not eliminate compliance with the law but do have a perceptible influence on the manner in which the law can be applied.”³²⁰¹ The tribunal stated that “the Claimant cannot ask to be entirely beyond the reach of the abnormal conditions prompted by the crisis”, but “at the same time, it would be wholly unjustifiable that the Claimant be overburdened with all the costs of the crisis... in light of the subsidization that the Claimant has in effect had to meet in respect of other businesses in Argentina, a burden which if necessary has to be born by the Government, at

³¹⁹⁵ Ibid., at paras. 197-199

³¹⁹⁶ Ibid., at para. 419

³¹⁹⁷ Ibid., at para. 420

³¹⁹⁸ Ibid., at para. 154: “Justice, however, is not as blind as it is often thought and this Tribunal acknowledges that changing realities had an impact on the operation of the industry and the governing legal and contractual arrangements.”; Ibid., at para. 356: “while the crisis in and of itself might not be characterized as catastrophic and while there was therefore not a situation of force majeure that left no other option open, neither can it be held that the crisis was of no consequence and that business could have continued as usual, as some of the Claimant’s arguments seem to suggest. Just as the Tribunal concluded when the situation under domestic law was considered, there were certain consequences stemming from the crisis. And while not excusing liability or precluding wrongfulness from the legal point of view they ought nevertheless to be considered by the Tribunal when determining compensation.”

³¹⁹⁹ Ibid., at para. 211

³²⁰⁰ For Hardship see *ibid.*, at paras. 221-239; for State of Necessity see: *ibid.*, at paras. 306-390; The tribunal’s application of Articles of the International Law Commission (ILC) on State Responsibility and Article XI of the BIT, which allowed measures “necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests” in relation to the state of necessity doctrine was criticized, but not annulled by the *ad hoc* Committee, which concluded that, whatever may have been the errors made in this respect by the tribunal, there was no manifest excess of powers or lack of reasoning in the part of the award concerning Article XI of the BIT and state of necessity under customary international law. *CMS Gas Transmission Co. v. Argentine Republic* (ICSID Case No. ARB/01/08) Annulment Decision, Sept. 25, 2007, at paras. 124-150

³²⁰¹ *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8, Award of the Tribunal (May 12, 2005), at para. 240

least in part.”³²⁰² In the tribunal’s view, the crisis had in itself a severe impact on the claimant’s business, but this impact must to some extent be attributed to the business risk the Claimant took on when investing in Argentina, this being particularly the case as it related to decrease in demand. The tribunal stated that “Such effects cannot be ignored as if business had continued as usual. Otherwise, both parties would not be sharing some of the costs of the crisis in a reasonable manner and the decision could eventually amount to an insurance policy against business risk, an outcome that, as the Respondent has rightly argued, would not be justified. On the other hand, a number of the measures adopted did indeed contribute to such hardship and the burden of those ought not to be placed on the Claimant alone.”³²⁰³

Accordingly, the effect of crisis was taken into account during the DCF analysis when projecting the gas demand trends.³²⁰⁴ The approach of ‘sharing of costs’ also seems to have influenced the way, in which the tribunal accepted or modified various assumptions, which were the basis of CMS’s expert report, but those may not be definitely established from the text of the award, since the tribunal examined two different DCF scenarios (one in the “no regulatory change” context and the other for the post-measures “new regulatory context”)³²⁰⁵, and the consequences of mathematical operations that lead to the final figure did not feature in the award.³²⁰⁶ After those modifications, the tribunal arrived “at a DCF loss valuation of US\$133.2 million for the Claimant on August 17, 2000, representing the compensation owed in that regard by the Respondent to the Claimant at that date”.³²⁰⁷ Thus, it can be argued that although deciding that the compensation standard of expropriation cases was found appropriate in this particular case of breach and that the date to be relied upon for the computation of values would be the date of breach³²⁰⁸, the tribunal did not reallocate the risks of negative events subsequent to the breach entirely to the Government for its illegal conduct, but engaged in a balancing exercise between the interests of the investor and the host state.

3. Concluding Remarks

Under *lex mercatoria*, the first established rule relevant to the damages for non-performance is the principle of full compensation, which requires the decision maker to give effect to the expectation of the aggrieved party from the performance of the contract by putting it into as good a financial position as that in which it would have been if the contract had been duly performed. The determination of the reasonableness of this expectation and, thus, the amount of recoverable damages under the principle of full compensation appear, in the first instance, as an issue of contextual interpretation and supplementation of the articulated rules in the

³²⁰² Ibid., at para. 244

³²⁰³ Ibid., at para. 248

³²⁰⁴ Ibid., at paras. 442-448

³²⁰⁵ Ibid., at para. 422

³²⁰⁶ E.g. the determination of the equity discount rate: *ibid.*, at paras. 450-455

³²⁰⁷ Ibid., at para. 468

³²⁰⁸ More specifically, the tribunal determined the relevant date as August 17, 2000, the day before an Argentine court issued an injunction, pending a decision on the challenged legality of the US PPI adjustment, for the suspension of both the agreement of the representatives of the gas companies, subject to certain conditions to defer the US PPI adjustment of the gas tariffs, and Decree No. 669/2000, which embodied the new arrangements, while recognizing that the US PPI adjustment constituted a legitimately acquired right and was a basic premise and condition of the tender and the offers. *Ibid.*, at paras. 61, 62, 441 It should be noted that the date “August 18, 2000” was argued by the Claimant as the date of beginning of a process that had the effect of indirect and creeping expropriation of the Claimant’s acquired rights. *Ibid.*, at para. 256

particular circumstances of the case. For that reason, it is observed that, in the arbitral practice, while there is usually a clear winner on the question of liability as a matter of law, the ruling on damages is frequently less categorical, and it is argued that the parties feel that if they were clearly right, they should have been awarded the full measure of damages requested, and perceive arbitrators as too conciliatory, and “splitting the difference”.³²⁰⁹

The matters of fact and law in the determination of the amount of recoverable damages are closely intertwined under *lex mercatoria*, due to the prevalence of the contextual approach to the issue of causation in the established limitations to the amount of damages. The decision maker applying *lex mercatoria* should first analyze the causal connections between the alleged loss, on the one hand, and the parties’ respective failures to perform their specific and residual contractual obligations and such events that are subject to specific or residual risk allocations, on the other. Then, the decision maker may rely on estimates and approximations in the assessment of the respective weight of all causes and, if necessary, in a subsequent reduction in the amount of the alleged loss, as long as the causal connections are reasonably certain, in accordance with the established limitation of certainty of damages, rather than all-or-nothing solutions of the national legal systems, in order to give effect to the reasonable expectations of the parties in a more accurate manner. Thus, the decision maker is required not only to base its assessment on the available evidence, but also to ascertain the causes of the loss within the framework of the law between the parties, which means the specific or residual contractual rights and obligations as well as the specific or residual allocation of risks under the transaction. After determining the liability of a party for non-performance, the decision maker applying *lex mercatoria* should establish the existence and extent of the loss incurred by the aggrieved party by focusing, in the first instance, on the causes of the loss the aggrieved party alleges that it incurred. In this regard, the decision maker should take into account two categories of potential causes in order to determine the amount of recoverable damages as accurately as possible.

In the first category, the decision maker should take into account certain events that are related to the contractual relationship and can be considered as instrumental in giving rise to the loss allegedly incurred by the aggrieved party due to the non-performance. Where those events are considered as a cause of the alleged loss, they will have the effect of limiting the amount of damages, to the extent that the risks of their occurrence are assumed by the aggrieved party under the specific or residual allocations of the risks. For instance, the non-performing party will not be liable to pay for the loss incurred by the aggrieved party as a result of non-performance, where such loss was unforeseeable for the non-performing party at the time of contracting, since the risk of relevant unforeseeable events that caused the loss will be considered as being allocated to the aggrieved party. This risk allocation will be derived from the contract terms or the chosen default rules, or from the relevant trade usages, the applicable national law or the established rule of foreseeability of loss. Similarly, other events that contributed to the loss of the aggrieved party will have the effect of limiting the amount of recoverable damages as a matter of causation and interpretation of contract and its supplementation with individualized terms, which determine whether such events fall under the aggrieved party’s sphere of risk, such as investor’s or contractor’s risk, under the specific or residual risk allocations, regardless of whether the applicable default rules recognize such concepts as contributory negligence or comparative fault. In the same vein, regardless of the position of the relevant national legal system to the issue of mitigation of damages, the risk of

³²⁰⁹ Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 658-659

prolonged inactivity of the aggrieved party after the non-performance will belong to the aggrieved party, if it is not specifically reallocated by the contract, or residually allocated by the decision maker to the non-performing party on the basis of the considerations of reasonableness and the ordinary course of events in the order of international commerce.

In the second category, the decision maker should consider the effect of the failure of the aggrieved party to perform its specific or residual contractual obligations relating to the periods relating to both prior and subsequent to the non-performance. Such obligations can be found in the terms of the contract or the default rules of national laws chosen by the parties, or derived by the decision maker from the established rules in the particular case, such as trade usages in the narrow sense, or the default rules determined by the decision maker to be applicable. The failure of the aggrieved party to perform such obligations may lead to a reduction in the amount of damages, if the failure can be considered as a cause contributing to the loss suffered by the aggrieved party. In the period prior to non-performance, the aggrieved party will firstly be under an obligation not to interfere with the performance of the other party under the basic principle of good faith and fair dealing. In some cases, the contract may specifically provide a sequence of obligations, under which one party's contractual obligations are explicitly recognized as a condition for the proper performance by the other party. In the period subsequent to the non-performance, the aggrieved party may be under specific or residual obligations to request the non-performing party to cure its non-performance under the contract, or to consider properly an offer made by the non-performing party to cure its non-performance, such as where it is provided so in the contract or the applicable default rules, or where substitute arrangements would be unreasonable. Thus, such obligations generally require the aggrieved party to cooperate with the non-performing party. Yet, they may also require the aggrieved party to protect its own interests. In this sense, the aggrieved party may be obliged to exercise due diligence during the period of contract negotiations in seeking information as to particular risks, which are allocated to it by the contract terms or established rules in the particular case, such as trade usages or other practices. Similarly, under the principle of foreseeability, where only one of the parties foresees a particular loss that may arise from the non-performance of the other party, the former party should disclose the risk to the latter before contracting, and pay him to assume it, in order to protect its interests in the full compensation of damages.

Thus, in abstract terms, the decision maker applying *lex mercatoria* to a case of damages for non-performance will determine, through a contextual approach, whether or to what extent the loss allegedly incurred by the aggrieved party was caused by the non-performance and the events attributable to the risk sphere of the non-performing party, and whether or to what extent such loss was caused by the failure of the aggrieved party to perform its specific or residual obligations and the events attributable to the risk sphere of the aggrieved party. In these determinations, the decision maker will evaluate the available evidence, by resorting, if necessary, to the test of reasonable persons of the same kind as the parties placed under the same circumstances and award damages in accordance with the established rule of certainty of damages. Thus, the damages will be awarded only for the loss, which can be considered as being directly caused by the non-performance and the events attributable to the risk sphere of the non-performing party, provided that the existence of the loss and its causal connections can be established with a reasonable degree of certainty. However, such certainty will generally not be sought for the extent of loss, since the decision maker will have the discretion to set the amount of damages even where such amount cannot be established with a reasonable degree of certainty, as long as the existence of loss is sufficiently certain. This

discretionary power will be derived from the applicable default rules or from the established rule of certainty of damages, which require the exercise of equity *infra legem*.

In ICC Case No. 9950, the arbitral tribunal aptly referred to and consolidated the law applicable to the merits as chosen by the parties in their contract, both the substantive and procedural law at the seat of the arbitration, and the UNIDROIT Principles, in order to demonstrate that the decision makers have discretion in the assessment of damages, and such discretion does not amount to their acting as *amiable compositeurs* and exercising equity *contra legem*. Under the relevant contract, the defendant, a French company, undertook to design and supply equipment for an industrial plant and to supervise the construction of the plant. The claimant, an Egyptian company, initiated arbitral proceedings, in which it claimed loss of profits, due to the defendant's faulty design and performance, plus various other losses and expenses, which led to complex questions as to the quantification of the losses. The contract was governed by Egyptian law. The arbitral tribunal was satisfied that the claimant suffered substantial losses. The tribunal stated that "An Arbitral Tribunal must not be deterred by the complexities of quantification from awarding full compensation to an aggrieved party."³²¹⁰ In this regard, the tribunal referred to the Egyptian Civil Code, which "places a responsibility on a judge to fix the amount of damages" and to the decisions of the Egyptian Court of Cassation, which "referred on a number of occasions to the elements of judicial discretion in the allocation of damages". The tribunal also noted that, under Swiss law, the law at the place of arbitration, "Article 42 of the Swiss Code of Obligations recognizes an element of discretion in cases where exact damages cannot be quantified". The tribunal found further support for such an approach in the statement of the principles for the assessment of damages in Articles 7.4.1-7.4.3 of the UNIDROIT Principles. However, the tribunal emphasized that the discretion in the assessment of damages operates within the confines of a scrupulous examination of the evidence presented by the parties, and it must avoid acting as an *amiable compositeur*. The tribunal also noted that it was required by the terms of reference and Swiss law to rule on all of the claims and counterclaims of the parties. The tribunal considered that it would fail in its duty to the parties, and arguably leave the award open to challenge as *infra petita*, if it declined to award damages simply on the basis of the complexities of their quantification.³²¹¹

The contextual approach to the issue of causation will prevail in the first instance in the determination of the amount of recoverable damages under *lex mercatoria*, and enable the decision maker to pay attention to the articulated or established limitations of foreseeability, mitigation and contribution, whether it is called upon to decide under a specific national law or not. Then, estimates and approximations of the decision maker will follow in the context of actual quantification of recoverable damages through the rule of certainty. Such estimates and approximations eventually govern, to a great extent, the determination of the amount of loss that can be recoverable by the aggrieved party as damages on the basis of the specific or residual contractual obligations and risk allocations. Particularly, they will have an effect on the final sum to be awarded as lost profits, an element of the full compensation.

³²¹⁰ ICC Final Award in Case 9950, June 2001, ICC International Court of Arbitration Bulletin, Special Supplement, UNIDROIT Principles: New Developments and Applications, (2005), at 78

³²¹¹ *Ibid.*, at 79; Also see Iran US Claims Tribunal Award in Case No. 941 (528-941-3), March 6, 1992, W Jack Buckamier v. the Islamic Republic of Iran, Tehran Redevelopment Corporation, Bank Mellat, Hejrat Branch, Yearbook Commercial Arbitration, (1993), at 309: "it is established Tribunal practice that when the circumstances militate against calculation of a precise figure, the Tribunal is obliged to exercise its discretion to determine the amount involved."

The default rules provided by the national legal systems and international instruments provide little or no guidance on how lost profits should be calculated, and simply give the decision maker broad discretion to fix damages for lost profits. In the context of international transactions, training has been available to enable contract negotiators and advisers, as well as parties in arbitrations, to deal more effectively with the issues related to damages. In arbitrations, costs and damages analysis has been developed and presented by accounting and financial professionals. Major accounting and consultancy firms have departments specifically versed in the quantification of damages to ensure they are as certain as they can be. Most international arbitral tribunals devote the necessary time to assess the evidence provided by those specialists in order to establish, with a satisfactory degree of certainty, the amount of damages claimed.³²¹² However, many analyses and methods developed for quantification of damages are still based on estimates and approximations. In *ADC Affiliate Limited and ADC & ADMC Management Limited v. Republic of Hungary*, the ICSID tribunal underlined its discretionary assessment in arriving at the final sum as the amount of damages: “The Tribunal is of course grateful to the experts on both sides for their enormous help on the issue of damages. However the Tribunal feels bound to point out that the assessment of damages is not a science. True it is that the experts use a variety of methodologies and tools in order to attempt to arrive at the correct figure. But at the end of the day, the Tribunal can stand back and look at the work product and arrive at a figure with which it is comfortable in all the circumstances of the case.”³²¹³ The ad hoc tribunal in *Himpurna* case similarly commented that: “To be fair, there is nothing new under the sun. *Lucrum cessans* has always been an inexact science. As the arbitral tribunal put it in the *Delagoa Bay* case almost exactly one century ago: “such a computation made in advance on the basis of purely theoretical data cannot hope to be absolutely accurate but only comparatively likely”.”³²¹⁴ Even so, the tribunal added that “There is no reason to apologise for the fact that this approach involves approximations; they are inherent and inevitable. Nor can it be criticised as unrealistic or unbusinesslike: it is precisely how business executives must and do, proceed when they evaluate a going concern. The fact that they use ranges and estimates does not imply abandonment of the discipline of economic analysis; nor when adopted by the arbitrators does this method imply abandonment of the discipline of assessing the evidence before them.”³²¹⁵

It is observed that while international arbitrators tend to be conservative with respect to lost profits, in view of the fact that international contracts are fraught with greater uncertainties than domestic ones, they award some measure of damages, if they believe that in the normal course of events it was reasonable to anticipate some profits, even if those damages may not be proved to a mathematical certainty or by complete documentary proof.³²¹⁶ It can be said that the following statement written in 1927 in relation to the international law still preserves its validity even in the private disputes. “The border line between direct and indirect damages,

³²¹² Gélinas, Paul-A., *General Characteristics of Recoverable Damages in International Arbitration*, in Yves Derains & Richard H. Kreindler, (eds.), *Evaluation of Damages in International Arbitration*, ICC Publication No. 668, 2006, at 13

³²¹³ *ADC Affiliate Limited and ADC & ADMC Management Limited v. Republic of Hungary* (ICSID Case No. ARB/03/16) October 2, 2006, at para. 521

³²¹⁴ *Ad hoc (UNCITRAL) Case, Himpurna California Energy Ltd (Bermuda) v. PT. (Persero) Perusahaan Listrik Negara (Indonesia)*, Final Award, 4 May 1999, at para. 578

³²¹⁵ *Ibid.*, at para. 580

³²¹⁶ Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 659

or between prospective and merely speculative profits, is seldom clear, and its determination is often dependent upon the subjective estimate of the arbitrator, who is, in fact, guided not so much by the technical distinctions between different kinds of damages, as by the wish, perfectly justified in law, to afford full redress to the injured. But to maintain that international law disregards altogether compensation for *lucrum cessans* is as repellant to justice and common sense, as it is out of accord with the practice of international tribunals.³²¹⁷

In the context of state party disputes involving expropriations or other breaches of contracts by the state party, the claims for lost profits has become particularly problematic, when the state party's actions not only injures the investor's business, but also destroys it, and the tribunal must determine the value of the business lost. The standard of compensation on the basis of the fair market value, which determines the price that the hypothetical willing buyer would pay the hypothetical willing seller, includes not only the tangible assets of the business lost, but also the stream of profits it can be expected to produce over its lifetime. The compensation in this context usually requires cash flow projections, which have an element of speculation. The element of speculation in the calculation of the investor's lost profits increases with the number of years to which a projection relates, yet the period of time that forms the basis of the projections into the future may not be reduced by the decision maker on the basis of the rule of mitigation, where the investor cannot be reasonably expected to mitigate such loss, to the extent the state's actions destroy its business. In this context, the decision maker should engage in a balancing exercise between the interests of the parties in order to ensure that neither party exploits the other. Thus, the claims for lost profits are treated differently from the claims for lost profits in the context of private party disputes.

First, the claim of the investor for lost profits in a state party dispute may be denied where their amount cannot be established with a sufficient degree of certainty, if the business is not a going concern that can be considered as a legally protected interest of sufficient certainty to be compensable as lost profits. Particularly, where the relevant investment lacks a sufficient history of profits for projecting future profitability, and the post-breach events further render the future profitability of business highly speculative, the decision maker may deny a claim for lost profits on the ground of uncertainty, even if the prospect of profits can be considered as reasonably certain when the investor engaged in the project. The rejection of lost profits for the lack of certainty of loss ensures that the investor, which has made only a small fraction of the anticipated investment, may not exploit the public funds of the state party by making a substantial profit on the basis of an award of damages without having to make the investment that was originally contemplated for the benefit of the state and its citizens.

Secondly, in cases of unlawful expropriations, the decision maker may adopt, as the basis of compensation, the valuation as of the date of award rather than the date of expropriation, if the first valuation results in a greater sum than the second due to the improved business conditions during the interim period. This is a residual risk allocation implied by the customary international law, and it precludes the state party from arguing that the improved business conditions were unforeseeable at the time of expropriation. This risk allocation prevents the exploitation of the economic windfall on the part of the states that have illegally imposed measures to take over the investments, whose business conditions turned out to be

³²¹⁷ Lauterpacht, Hersch, *Private Law Sources and Analogies of International Law: with Special Reference to International Arbitration*, Lawbook Exchange, 2002, (Originally published: New York: Longmans, Green and Co., 1927), at 148-149

better than expected. It also implies that the state may not invoke the standard of valuation as of the date of award to pay a lower compensation than the standard of valuation as of the date of expropriation, where the investment would have lost value in the absence of the unlawful expropriation. Thus, the expropriating state is precluded from benefiting its own illegal act, which forced the investor to transfer its investment to the state, and prevented it from exercising the option of selling the investment at arm's length when the business conditions were better.

Finally, even if the risks of subsequent events that increase the burden of the state party's performance of its obligations, such as financial crises or currency devaluations, are allocated to the state party specifically or residually, such burden arising from the materialization of those risks may be shared between the parties by the decision maker utilizing the flexibility in the estimates and approximations in the calculation of the lost profits of the investor, where the imposition of damages awarded on the basis of a calculation of lost profits in total disregard of the fact that the effect of subsequent events on the investment would be ruinous to the state and its citizenry. However, despite the calculation of damages on that basis, the burden on the state party may still appear excessive in relation to the gain to be obtained by the investor, where the latter has the contractual right to make further investment and to claim damages for its lost opportunity to make profit, thereby increasing the likelihood of exploitation on the part of the investor. In this regard, the Himpurna award, which deprived the investor for claiming damages for its lost opportunity to make profit, does not seem to set a precedent, due to its failure to provide sufficient insight as to the basis of such deprivation, i.e. its innovative theory of "anticipatory abuse of rights". Thus, the decision maker applying *lex mercatoria* should still take into account such loss but, in its quantification, he should attempt to utilize the flexibility in the relevant estimates and approximations to share the burden between the parties, in order to render an award that would be more lenient with the state party, while "respecting the imperatives of contractual reliability", thereby avoiding undue disruption in the internal order of the state party and enabling the peaceful development of the overall order of international commerce. This can be considered as the recognition of the equitable component in the evaluations of quantum in the context of state party disputes.

Under *lex mercatoria*, the inevitable persistence of estimates, approximations and equitable considerations in the quantification of the damages should not be readily considered as prescribing a decision of "splitting the difference" between the parties, since such a decision implies a process of conciliatory decision making and an underlying intention on the part of the decision maker to satisfy both of the parties by giving something to both parties. As outlined above in abstract terms, there are many factual and legal considerations to be taken into account by the decision maker in determining the amount of recoverable damages, and those clearly indicate an exercise of equity *infra legem* and the concern for accuracy in determining and giving effect to the reasonable expectations of the parties, in an area of substantial uncertainty. The parties to a contract may reduce this uncertainty to some extent by providing contractual limitations to the amount of damages for non-performance, but even such limitations will be subject to the interpretation, supplementation or intervention of the decision maker exercising a considerable degree of discretionary power. Thus, the decision maker applying *lex mercatoria* should articulate in the final award, as explicit as possible, its abstract reasoning, which has been exercised in applying the articulated or established rules and evaluating the available evidence. The decision maker should render an award of damages, which clearly shows that the rationale underlying the award is the accuracy, and not compromise in a particular case, by expressly resorting to those limitations to the amount of recoverable damages, which arise from the causal connections between the loss and the

relevant events, articulated rules and established rules in the particular case, in order to enable the parties to comment and cooperate in the utilization of the knowledge of the particular circumstances of time and place.

6. CONCLUSION

The order of international commerce is complex and spontaneous. In the order of international commerce, a multiplicity of elements of various kinds, such as states, businessmen, and international governmental or non-governmental organizations, are closely related to each other, and none of those elements may claim to assume control on this extended and more complex order, in contrast to an internal order of an organization, without interfering with and impeding the forces producing its spontaneity and effectiveness. This order is of such complexity that can be designed neither as a whole, nor by shaping each part separately without regard to the rest, but only by consistently adhering to certain principles that establish abstract relations among the multiplicity of those elements. In this order, the knowledge is so widely dispersed throughout those elements that no single organization could acquire enough of it to articulate and stabilize *ex ante* the normative expectations of individuals under a specific and deliberate purpose. Thus, the actions of individuals owe their effectiveness not only to *ex ante* articulated forms of knowledge governing those actions by known aims or known connections between means and ends, but also to the knowledge of the particular circumstances of time and place which, practically, puts each individual in an advantageous position to pursue his own purpose, over all others. Such knowledge is unique to its possessors and its utilization requires that the decisions depending on it are left to them or are made with their active cooperation.

In this order, the success of an individual's actions in achieving his purpose, ultimately, depends on his capacity to adapt his actions both to the particular facts which he knows and to other facts he does not or cannot know. Such an adaptation occurs through abstractions, whereby the individual deals with a reality he cannot fully comprehend. Abstractions form the basis of individual's capacity to act successfully in an order very imperfectly known to him. By means of abstractions, the individual in this order understands its basic principles, converts his incomplete knowledge into a workable format, and forms reasonable expectations on the basis of his knowledge of the particular circumstances of time and place and the basic principles that the ongoing order of actions rests on. Reasonableness of expectations in this order depends on the possibility of maximizing the expectations of the elements of the order as a whole being fulfilled and corresponding, in light of the common interest of all the elements of the order, which is the ability to make feasible plans for particular purposes without impeding the very order providing this ability. The order of international commerce arises from the separate knowledge of all its elements, without this knowledge ever being universal in its entirety. Consequently, the degree of power of *ex ante* control over the expectations is much smaller than that which could be exercised over an internal order of an organization. There are many aspects of the order of international commerce over which the elements possess no control at all, since the control in those aspects is deferred to the *ex post* processes, which utilize the dispersed knowledge when confronted with a particular constellation of circumstances. If any authority claims to assume *ex ante* control on those aspects, it shall not be able to do so, without interfering with and impeding the forces producing the spontaneous order.

The function of law in this order should be the preservation and restoration of this order, which consists of a system of abstract relations among various elements, and whose abstractness enables the order to persist while all the particular elements it comprise change. The order will always be an adaptation to a large number of particular facts which will not be known in their totality to anyone. In this order, there will naturally be some rules, which are

the products of deliberate design, and there will always be deliberate organizations in which groups of individuals will join for the achievement of some particular ends. However, those rules and organizations will be integrated into this more comprehensive and spontaneous order, and the coordination of the activities of all these separate organizations, as well as of the separate individuals, will be brought about by the forces making for a spontaneous order. In this order, the law should be the means of enforcing the established manner of doing things and tacit knowledge, which can only be traced *ex post* by means of abstractions that utilize the knowledge of particular circumstances of time and place. These established rules indicate the correspondence of the expectations of the elements of this order and, thus, they are the fundamental means of producing and maintaining a spontaneous order.

Since the sixteenth century, the concept of *lex mercatoria* have been understood as a response to the disturbances in this spontaneous order, because the political authorities, who tend to try to turn their domain into an organization, have attempted to make laws without taking into account the basic principles on which this order rests and by substituting their knowledge articulated in their laws for the knowledge of particular circumstances of time and place possessed by the parties to a particular commercial contract. In the sixteenth and seventeenth centuries, the proponents of *lex mercatoria* tried to protect the capacity for abstractions of the medieval mercantile courts, which took into account the knowledge of the parties to a particular dispute, applied such rules that were not developed with any deliberate purpose, but served to maintain and improve the order of actions, which the already existing rules made possible and in which the individual merchants were able to make feasible plans. In the nineteenth century of Germany, the lawyers thought that the use of Roman law displacing customary law that grew out of the soul of the Volk similarly restricted the utilization of knowledge of particular circumstances of time and place through the capacity of *ex post* decision makers for abstractions, and they argued, on the basis of the concept of *lex mercatoria* that, in commercial matters, judges must be able to use their common sense and to disregard all juristic notions arising from Roman law in order properly to grasp and master the nature of the commercial transactions. Similarly, some lawyers from common law tradition opposed to its constricting formalism during the late nineteenth century and early twentieth century, and promoted *lex mercatoria* as the customary law discovered by the sound instincts of decision makers specialized in commercial matters.

In the twentieth century, the modern *lex mercatoria* doctrine emerged for the restoration of the liberal and spontaneous order of international commerce, which was disturbed by the political divisions and conflicts between the states. The traditional conflict of laws regime was indifferent to these issues in the determination of the applicable law to the international transactions. In this context, the spontaneous order of international commerce was most obviously attacked when some states attempted to repudiate their contractual obligations towards foreign investors in contravention to the liberal principles of contract law. These host states claimed the application of the laws made by their own organizations in an attempt to overcome those liberal principles, which bound them to freely undertaken contractual obligations. The arbitral tribunals resolved the disputes between those states and private parties on the basis of an abstract reasoning and applied general principles of law, disregarding the traditional conflict of laws regime and the collective actions of some states to change the existing order profoundly. The gradual recognition by the states of this practice of transnational arbitration indicated the capacity of arbitrators to render valid decisions on the basis of an abstract reasoning, and constituted one of the pillars of the theories of the first generation of the proponents of modern *lex mercatoria* doctrine. The first generation purported to extend the capacity for abstractions in *ex post* judicial processes to the resolution

of contractual disputes between private parties, through their ideas of an autonomous legal system for the international merchants coming from different jurisdictions and legal cultures, in the context of political division between North and South on the one hand, and between East and West on the other. Later, the second generation understood *lex mercatoria* as a method for decision making whereby the idiosyncratic or outdated rules of law found in a national law can be disregarded by ex post the decision maker in order to preserve the spontaneous order of international commerce.

The dissertation has suggested a new theory of *lex mercatoria*, which accounts for the complex and spontaneous order of international commerce. This theory differs from the majority of theories discussed so far in the modern doctrine of *lex mercatoria*, which has failed to provide a proper reflection of the abstract relations in the order of international commerce, due to their search for such mechanisms that may ironically turn the domain of this order into a form of organization, similar to the national legal systems. The modern *lex mercatoria* doctrine, representing it either as a legal system or as a method of decision making, has implicitly set the stabilization of expectations as an aim for *lex mercatoria* to have an ex ante effect on the incentives and behaviors of international merchants as well as their contracts, similar to the effect of national laws on their subjects. Therefore, the concept of *lex mercatoria* has always been closely connected to the harmonization and unification of the national laws. However, such an approach rendered the modern *lex mercatoria* doctrine vulnerable to the attacks of its opponents due to the lack of precision and completeness of *lex mercatoria*. Thus, it is strongly argued by the opponents that *lex mercatoria*, because of its inherent uncertainty, fails to provide the international merchants with a set of rules, which is sufficiently accessible and certain to permit the efficient conduct of their transactions, and leads to doubts about its claim that it is more appropriate, in its content or methodology, than national legal systems, for the resolution of disputes arising from international contracts. Under the traditional understanding, *lex mercatoria* increases the likelihood of an unreasonable and uncertain application of the law governing the contractual disputes, while the wide acceptance of the principle of party autonomy by national legal systems is essentially aimed at reducing the uncertainty created by the territoriality of institutions in the order of international commerce.

The issue of uncertainty should be examined in the light of the nature of the order of international commerce, which is distinct from the internal orders of the national legal systems. This distinct nature requires an understanding of the concept of *lex mercatoria* as a different method from the national legal systems in dealing with legal uncertainty. An important function of any legal regulation is to deal with legal uncertainty, which arises from the imperfect knowledge of individuals about when and under what conditions the coercive power of the law is exercised. However, there is an undeniable tension between reducing legal uncertainty and providing justice in a particular case. Thus, the national legal systems consist of rules and standards. The rules arise from the formal consolidations of similar instances, on the basis of usage, custom or case law, in accordance with the position of authorities in the legal system, following a particular purpose. The rules are articulated forms of the knowledge of particular circumstances of time and place in the internal order of the legal system. Standards in a legal system authorize the decision makers to exercise abstract reasoning, and give legal character to their own consolidations of relevant materials on the basis of their specialization. The decision maker gives content to those standards ex post by weighing all essential facts, interests and expectations of the parties to a particular case and ascertaining justice in each individual case. Since the tension between legal certainty and justice in a particular case is mainly related to the adaptation to changes in the particular circumstances of

time and place, standards leave the ultimate decisions to the ex post decision makers, who are in a position to obtain the knowledge of the relevant changes and of the sources available to meet them when confronted with particular cases.

However, the national legal systems tend to deal with legal uncertainty mainly on the basis of formal consolidations, thereby converting legal uncertainty as much as possible into legal risks. Formal consolidations achieve ex ante stabilization of expectations through certain legal structures, such as legislation, or case law, and the emerging ex ante effect turns uncertainty into risk. The conversion of legal uncertainty into legal risk forms an obstacle in the ex post decision making process to the utilization of the parties' knowledge of the particular circumstances of time and place, most of which is dispersed and tacit in the order of international commerce. Under the national legal systems, such expectations, which can be considered as reasonable from the ex post perspective of abstract reasoning, utilizing the knowledge of the particular circumstances of time and place, may exceptionally be given effect to, despite the existence of formal consolidations, when the application of those legal structures results in grave and evident injustice in a particular case. However, injustice in this sense means that such an application must result in a great disturbance in the internal order of the system. In those situations, most of the national legal systems allow the decision maker to use his power of discretion within their framework and decide in accordance with the standards of that system, thereby utilizing the tacit knowledge that is instrumental in keeping a society together. The decision maker is forced to transcend the law by using his power of discretion within the framework of the legal system in order to achieve justice in a particular case, and to translate this experience into legal decisions for the self-referential structure of the legal system.

As far as the control of legal uncertainty is concerned, *lex mercatoria* represents an alternative to a legal system in dealing with legal uncertainty, to the extent that *lex mercatoria* depends on the national legal systems for the coercive enforcement of legal rules. It provides the opportunity to turn legal uncertainty into a gain in the sense of restoration of the spontaneous order of actions in the context of international commerce, which has been disturbed by the contractual dispute, but not into a risk for other transactions, since there is no organization in the order of international commerce, whose task is to provide formal consolidations and to ensure that each ex post decision maker translates his experience with legal uncertainty into some legal structures so as to turn *lex mercatoria* into a legal system stabilizing expectations. Even in a legal system, there is always a need for such mechanisms involving the techniques of flexibility and adaptability that allows the ex post decision maker to utilize the tacit component in the knowledge of the particular circumstances of time and place possessed by the parties, for the adaptation of the legal system to the ongoing order of actions that take place in any society of individuals. This need is simply greater in the order of international commerce, since the amount of knowledge that is common to the elements constituting the order is much more limited, in the absence of an organization collecting and directing the necessary knowledge. Thus, throughout the centuries, *lex mercatoria* has always been providing international merchants with an appropriate method of dealing with legal uncertainty in the order of international commerce, on the basis of the flexibility and adaptability in the ex post judicial resolution of contractual disputes, which recognizes the significance of the individual case and utilizes the knowledge of the particular circumstances of time and place, by putting the emphasis on the specialization in the decision making.

Due to the absence of an organization, which could acquire enough of the dispersed knowledge in the order of international commerce to provide legal structures establishing

formal consolidations, the ex post and specialized consolidations of the decision makers on the basis of an abstract reasoning become integral to the control of legal uncertainty in the order of international commerce. Before the individual act, *lex mercatoria* is in the form of a few basic principles, which constitutes the basis of the going order of international commerce. It does not manifest itself in already articulated forms, but it has to be discovered and articulated by the ex post decision maker through specialized consolidations that utilize the knowledge of circumstances of time and place possessed by the parties to a particular dispute and reconstruct its tacit aspect in accordance with those basic principles. The constant necessity of articulating rules ex post in order to ascertain and give effect to the reasonable expectations of the parties to a particular dispute requires of the decision maker a capacity for abstract reasoning to utilize the knowledge of the particular circumstances of time and place. In this context, the elements in the order of international commerce are confronted with the abstract nature of *lex mercatoria*, and the capacity of the ex post decision maker for exercising an abstract reasoning in the specialized consolidations that are required for the maintenance and restoration of this order. Thus, *lex mercatoria* is an alternative to the national legal systems, to the extent that the elements of the order of international commerce express their confidence in the specialization of the individual decision makers controlling legal uncertainty, in accordance with the common interest of those elements in the maintenance and development of the ongoing order on the basis of its basic principles.

Absent an ulterior guiding authority that provides confidence for the elements of the order of international commerce through the mechanism of formal consolidations, the question for the decision maker applying *lex mercatoria* should not be whether his actions are appropriate from some higher point of view, or served a particular result desired by an authority. The only public good with which the decision maker applying *lex mercatoria* can be concerned is the observance of the established rules that the individuals could reasonably count on for the successful pursuit of their purposes. His reasoning should not involve any ulterior purpose which somebody may have intended the rules to serve. The decision maker applying *lex mercatoria* serves to maintain and restore a going order that is not the deliberate design of anybody, and that is not based on the elements doing anybody's will, but on their expectations becoming mutually adjusted and corresponding. *Lex mercatoria* serves to enhance the stability of expectations not by determining a particular concrete state of things, but on the basis of an abstract order, which enables its members to derive from the particulars known to them expectations that have a good chance of being reasonable. The efforts of the decision makers applying *lex mercatoria* are part of the process of adaptation of the order of international commerce to the particular circumstances.

Thus, historically, *lex mercatoria* has always been associated with the flexibility and adaptability in the ex post judicial processes controlling legal uncertainty, as required by the spontaneous order of cross-border commerce, on the basis of the specialization of the decision maker in making use of knowledge of the particular circumstances of time and place, as an alternative to formal consolidations of the legal systems. In this understanding, the legal uncertainty is inherent in the concept of *lex mercatoria*. Unlike modern *lex mercatoria* doctrine, which commonly tries to provide tools to convert legal uncertainty into legal risk, this new theory of *lex mercatoria* embraces legal uncertainty and conceives it as a means for achieving fair and just outcomes in the disputes arising from international contracts. In this context, the fairness and justice mean the restoration of the order of international commerce, which has been disturbed by a particular dispute, and require the resolution of that dispute in a manner that maximizes the expectations of the elements of that order, which enables them to make feasible plans for the achievement of their individual purposes. In this understanding,

lex mercatoria is the law of adjudication on the basis of a few basic principles, which apply to the procedure of the decision making, the conflict of law analyses and the substance of the contractual disputes, leading to the application of a body of more specific rules appropriate for a particular bargain. These rules are derived from the tacit knowledge of the parties by means of specialized consolidations on the basis of the abstract reasoning of the decision maker, and they indicate the reasonable expectations of parties to a particular contract. The legality of those rules depends on the recognition of the freedom of contract as the presupposed basic norm of the spontaneous and liberal order of international commerce by the national legal systems providing legal enforcement, whereby the authorities will only be concerned about the outcome and procedural aspects of the ex post process of judicial decision making, but not the content of decision, which arises from lex mercatoria as a technique of thought that requires specialization.

As a result of its emphasis on the imperfect and tacit knowledge, lex mercatoria as the law of principled adjudication deals with the incompleteness of the rules articulated by the contracting parties on the basis of their knowledge of particular circumstances of time and place. Articulated rules consist of the contractual clauses and the default rules chosen by the parties to govern their contract, and create specific contractual rights and obligations as well as specific allocations of risks relating to the contractual relationship between the parties, to the extent that the parties are willing to incur transaction costs at the stage of contracting. Lex mercatoria mainly applies to the resolution of the disputes over the residual contractual rights, obligations and risk allocations. Those residual issues arise when the contractual terms or the default rules chosen by the parties contain standards, or they do not cover the particular issues in dispute due to their exactness. Some characteristics of transactions indicate the parties' preferences for the method of allocation of the residual contractual rights, obligations and risks, i.e. the method of dealing with legal uncertainty; in this regard, the preference for specialization over formal consolidations enables the application of lex mercatoria.

The dissertation has made a basic distinction between transactions governed through legal risk and transactions governed through legal uncertainty. The transactions governed through legal risk comprise discrete and short term contracts, where such contingencies that are not covered by the articulated rules are truly exceptional. These contracts are well suited to the formal consolidations provided for an internal order of an organization, as they do not necessarily require tailor-made solutions by virtue of the typicality of needs and expectations. The issues of residual contractual rights, obligations and risk allocations hardly arise in such transactions. In the transactions governed through legal risk, by choosing default rules provided for the internal order of an organization, the parties are able to foresee the applicability and possible outcomes of the application of such rules, and they can make legal risk assessments. The parties to such transactions accept that chosen default rules will apply, when they have failed to contract out those rules, namely when the legal risk materializes, unless there is an exceptional discrepancy between the rule and the situation, which requires the decision maker to transcend the articulated rules. Only in the unlikely case of the latter, lex mercatoria will be relevant to such transactions provided that the parties have not expressed their confidence in the system of an organization providing rules for the resolution of such discrepancy and the control of resulting legal uncertainty.

The transactions governed through legal uncertainty usually have a longer duration, for the longer the contractual duration is, the more questions of residual contractual rights, obligations, and risk allocations appear. Their structures or purposes are usually more complex or innovative. While the simple and common needs of individuals are the most

stable and predictable for an authority providing the formal consolidations for an internal order of an organization, as complexity or innovation increases, the uncertainty connected with foreseeing needs and satisfying them becomes greater. This complexity or innovation may likely be required by the circumstances surrounding the transactions, such as when many legal systems are involved in the scope of transaction, by the status of the parties, such as when there is a contract between a private individual and a state or state enterprise, or by the atypical form of the transaction, which have increased in number particularly after the change in the theory and practice of business organization and the recent move towards externalized business relationships in the order of international commerce. These long-term, complex or innovative business transactions, despite commonly involving long and detailed documents under the influence of Anglo-American contracting practices, usually contain gaps or include contractual clauses in the form of standards, and require the decision maker to give them content *ex post* by taking into account the knowledge of particular circumstances of time and place. The appropriate rules for the transactions governed through legal uncertainty should enable more than a mere transformation of legal uncertainty into legal risk. Such rules should arise from *ex post* processes, where specialization of the decision maker prevails over the formal consolidations of an organization, to produce some gain in the form of fair and just results for a particular case. Thus, *lex mercatoria* is mainly applicable to the international contracts governed through legal uncertainty.

While the disputes over residual contractual rights, obligations and risk allocations indicate that the transaction is to be governed through the conditions of legal uncertainty and they constitute the preliminary requirement for the applicability of *lex mercatoria*, its application ultimately depends on the parties' delegation of the control of legal uncertainty to the specialized decision maker, and the capacity of the decision maker to assume such a delegation. Moreover, when there is such a delegation, *lex mercatoria* is applicable, regardless of the characteristics of the transactions, in the determination of the limits of the parties' freedom of contract, through public policy considerations for the preservation and restoration of the order of international commerce. The delegation exists when the parties express their confidence in the specialization of the decision maker exercising an abstract reasoning in *ex post* consolidations for revealing the tacit knowledge of the parties that meets the deficit in their articulated knowledge, by discovering the established rules, on which the reasonable expectations of the parties rests. Whether the parties have expressed their confidence in the specialization of the decision maker can be determined on the basis of the institutional choice of the parties for the *ex post* judicial process and the capacity of the chosen decision maker for the abstractions. There are two types of judicial process from which the parties to international contracts are to choose, and their choice indicates their preference between specialization and formal consolidations in meeting legal uncertainty. Those are litigation before national courts, which indicates the preference for formal consolidations, and arbitration before international tribunals, which indicates the preference for specialization.

The national courts, whose jurisdictional power is derived from a national legal system, have a limited capacity to assume the delegation from the parties of the task of controlling legal uncertainty through their specialization. They do not have the sufficient capacity for abstract reasoning in *ex post* consolidations that are required for the application of *lex mercatoria* and for maximizing the possibility of correspondence of expectations of the elements in the order of international commerce. The national courts constantly attempt to ensure that the residual rights, obligations and risks arising from transactions governed through uncertainty are allocated by the guidance, direction or formal consolidations of a national legal system. They are required to apply the conflict of laws rules of their national legal systems, which

invariably lead to the application of a national law, and prevent the parties from excluding the application of any national law through a “negative choice of law” or from choosing non-national rules as the governing law. Almost all legal systems require the national courts to apply the applicable foreign law in the same manner as in its country of origin. In the case of failure to ascertain the contents of the applicable foreign law, from which residual questions emerge, most of the national legal systems require the national courts to apply the law of the forum as a last resort. Thus, if the parties prefer their contractual disputes to be adjudicated by a national court, the applicability of *lex mercatoria*, as the law of principled adjudication will be at minimum.

In such a context, the application of *lex mercatoria* by the national courts ultimately depends on the position of the higher authorities in a national legal system to the issue of meeting legal uncertainty. First, it is applicable in exceptional cases, where those authorities acknowledge that the justice in a particular case may require the court to decide outside the self-referential structure of the legal system, such as through the extensive interpretation for filling the contractual gaps on the basis of the presumed intentions of parties, or resorting to “equity *infra legem*” in the assessment of the relief that a party is entitled to. However, even in such exceptional cases, the judge’s judicial behavior in exercising abstract reasoning will mostly be characterized by his specialization as to the internal order of the relevant legal system due to his concentration on domestic cases. Secondly, *lex mercatoria* may be relevant in the context of a national court to the extent that the authorities in the relevant national legal system are receptive to the idea of developing the internal order of the legal system in line with the spontaneous order of international commerce. The national courts, as the organ of a legal system, necessarily have a concern for the development of the internal order of the relevant legal system. This concern is particularly apparent in the manner of application of the international restatements of contract principles in the context of a national court, which depends on the position of the authority, whose power is directed towards the generality of actions in the internal order of the legal system, rather than the specialization exercised by the judge in a particular case. Thus, the national courts refrain from relying on abstract reasoning in considering the applicable law, trade usages or customs, and from referring to the international restatements of contract principles for those purposes.

The international arbitrators, whose jurisdictional power is derived entirely from the parties’ agreement, have the ability to fully assume the delegation from the parties of the task of controlling legal uncertainty through their specialization. The finality of arbitral awards and the “general pro-enforcement bias” under the New York Convention and modern arbitration laws indicate the confidence of the states in the specialization of the arbitrators to render decisions, which are conducive to maintaining and improving the spontaneous order of international commerce. The national legal systems enable the international arbitrators to approach to the issue of conflict of laws as a matter of giving effect to the reasonable expectations of the parties. This approach has also effects on the ascertainment of the law or rules of law governing the substance of the dispute, whereby the arbitrators ascertain the content of the applicable law by having regard to the direct or indirect will of the parties, in the absence of which they follow the rules of their choice. The national legal systems generally recognize that the arbitrators have neither mandate nor function in the development of any national legal system, and their decisions will not become a part of the self-referential structure of any national legal system. Thus, even when the arbitrators apply a national law, they have the capacity to apply that law on the basis of the reasonable expectations of the parties to a particular dispute, and they are under no obligation to apply the law in exactly the same manner as a national court would do in the country of that law.

It is generally accepted that an international arbitral tribunal is not an organ of a legal system and it does not have a *lex fori*. This implies the absence of an organized hierarchy of a legal system, which could provide an effective appeal mechanism focusing on and ensuring the full compliance of a decision with the decision maker's *lex fori*. Thus, in the context of international arbitration, when proceedings for the enforcement of arbitral awards are brought in the national courts, the national court may not re-litigate the case. The national court reviewing an international arbitral award may not be motivated by a desire of integrating the award into its own legal system. Accordingly, the national courts increasingly refrain from focusing on which law was applied and how it was applied to the merits of the case by the arbitral tribunal. Their review of arbitral awards mainly focuses on two issues: whether the procedural manner in which the arbitral award is rendered is in compliance with the parties' intentions and the procedural public policy, and whether the enforcement of the award creates a situation that is unacceptable for the substantive public policy in the relevant legal system.

Thus, the arbitrators have the capacity for abstractions that are required for the application of *lex mercatoria*. In the context of international arbitration, the capacity for abstract reasoning is not dependent upon the position of any higher authority in a legal system to the problem of legal uncertainty. The arbitral tribunals are freed from the formal consolidations, which determine the nature, functions and applicability of trade usages, customs and general principles of law in the interpretation, supplementation and correction of the contract or its default rules. For instance, the arbitral tribunals have relied entirely on their specialization when deciding the applicability of international restatements of contract principles in assisting their specialized consolidations on the basis of an abstract reasoning for discovering the established rules, and evaluating their persuasive authority as indications of trade usages or general principles of law, or both. Moreover, in many cases, despite the confusion as to the concept arising from the complications of the modern *lex mercatoria* doctrine, the arbitral tribunals actually apply *lex mercatoria*, as the law of principled adjudication, as a result of their concern for giving effect to the reasonable expectations of the parties to a particular contract, by utilizing the finality of their decisions and the flexibility of decision making, provided by the arbitration laws and rules, with regard to the determination of the applicable law, the ascertainment of its content and the manner of its application to a particular dispute.

However, the fact that international arbitrators have the sufficient capacity to apply *lex mercatoria* does not mean that they will always utilize their capacity for abstract reasoning to maximize the possibility of correspondence of the expectations of the elements in the order of international commerce. In the exercise of such an increased capacity for providing justice in a particular case, the reasoning of arbitral tribunals, which determines the distinction between specific and residual contractual rights, obligations and risks, and their allocation in a particular dispute, sometimes seems unprincipled in the practice of international arbitration. Consequently, the parties to arbitration proceedings may sometimes have difficulties in predicting the substantive outcome of the dispute. This leads to speculations as to the factors, which potentially become influential on the judicial behavior of the arbitrators, such as their reputation in the arbitration market, the prospect of future reappointments, and the personal, financial or business relationships between the arbitrator and a party, its counsel, major law firms, circle of arbitrators, arbitral institutions or political powers. Indeed, although, in all cases, the duty of impartiality in terms of treating the parties with equality and giving each party a full opportunity of presenting his case remains intact, the types of situations in which issues of independence and impartiality arise are extremely varied and subtle, thereby leaving room for the personal or professional factors to exert an influence on the arbitrator's judicial

behavior. In this context, the arbitral tribunals' judicial behavior arguably reflects a tendency to "split the difference" between the parties under the influence of personal or professional connections, collegial decision making within the tribunals, or concerns for reappointment or reputation in the arbitration world.

The phenomenon of splitting the difference results from the arbitrators' increased capacity for abstract reasoning in relation to the particularities of an individual transaction, which is considerably freed from the rigidities of national legal systems. Thus, it is ultimately an impression arising from such an understanding that legal uncertainty can only be controlled by means of formal consolidations. In this context, the criticisms of splitting the difference in terms of compromise and unpredictable awards make sense only when the arbitral tribunals are not clear in their awards as to their legal reasoning, particularly on the issues of why the purpose of arbitration is to give effect to the reasonable expectations of the parties to a particular dispute and how this purpose is achieved by means of their solutions. However, they cannot be clear on those issues if their reasoning is in fact motivated by their self-interest, such as their connections and reputation in the arbitration world or the prospect of future reappointment.

The theory of *lex mercatoria*, as suggested in this dissertation, may help the arbitrators to motivate their judicial behavior with the reason why the accurate determination and enforcement of reasonable expectations of the parties to a particular contractual dispute matters in the spontaneous order of international commerce, and guide them in achieving such accuracy through a more principled decision making in accordance with the abstract relations between the elements in the order of international commerce. In particular, *lex mercatoria* allows for a more refined exercise of "splitting the difference", since it ensures that whenever the decision maker reduces the original claim amount by an equitable percentage, such reduction results from an exercise of equity *infra legem*, in the sense of an authorization by the articulated or established rules in the particular case, but not from an exercise of equity *contra legem*, seeking just to find a compromise between the claims of the parties and to satisfy both of them, even if it is in contravention of the law.

However, there is a conceivable tendency of arbitrators to refrain from referring to *lex mercatoria* explicitly due to the misconceptions about *lex mercatoria*, which are created by the modern legal doctrine presenting it as an autonomous body of non-national legal rules, directly applying to the substance of a contractual dispute either in lieu of national laws or in a supplementary manner. While *lex mercatoria* is not an autonomous legal system in the order of international commerce, it is not a method of substantive decision making either, because such an understanding ascribes only a default meaning to *lex mercatoria* and neglects its application in choice of law analyses and public policy considerations. The concept of *lex mercatoria* should not be merely related to a question of applicable law to an international contract in the sense of a choice between a national law and transnational law as the governing law of the contract, although it has been traditionally understood as being so, but, in more general terms, how a dispute arising from an international contract should be resolved, with a view to maintaining and improving the spontaneous order of international commerce on the basis of an accurate determination of reasonable expectations of the parties to a particular dispute, regardless of the application of national or non-national legal sources.

Lex mercatoria is an alternative to the national legal systems in meeting legal uncertainty in the adjudication of contractual disputes, and this understanding implies a far greater significance for *lex mercatoria* in the order of international commerce than what would

otherwise be expected from a mere option in the choice of law analyses. Lex mercatoria requires the decision maker to allocate the residual contractual rights, obligations and risks, which arise from the incompleteness of both contractual terms and applicable default rules, in accordance with the reasonable expectations of the parties, which rest on their knowledge of the particular circumstances of time and place, by maximizing the correspondence of the expectations of the elements in the spontaneous order of international commerce. Lex mercatoria theoretically reveals that the reasonable expectations of the parties matter, as a result of the importance of the knowledge of particular circumstances of time and place and the abstract relations among the elements of the spontaneous order of international commerce for its functioning. This understanding should motivate the reasoning of arbitral tribunals rather than their reputation, income or personal connections to the certain circles, law firms or arbitral institutions. The arbitrators should be aware of the function of lex mercatoria in the preservation and restoration of the order of international commerce and, thus, follow its basic principles.

The basic principles of lex mercatoria constitute the abstract schemata of thought that guides the decision maker resolving disputes arising from international contracts. The basic principle of freedom of contract under lex mercatoria allows the parties to structure and articulate their transaction to follow their individual purposes on the basis of their knowledge of the particular circumstances of time and place. The freedom of contract mainly has two functions: freedom to contract and freedom from contract. The freedom to contract enables the parties to allocate contractual rights, obligations and risks on the basis of their knowledge of the particular circumstances of time and place, through contractual clauses and by choosing a set of default rules, which can be in the form of a national law, international restatements of contract principles or codified trade usages. The freedom from contract requires the ex post decision maker to enforce the articulated rules comprising both the contractual clauses and the chosen default rules, and to refrain from imposing a different contract on the parties by substituting his own ideas of what the parties intended for the specific allocations of contractual rights, obligations and risks, to the extent they are ascertainable by the choices of the parties.

The freedom of contract as the basic principle of lex mercatoria also implies the ability of the parties to delegate the task of controlling the legal uncertainty to the ex post decision maker, and the decision maker applying lex mercatoria should observe the terms of that delegation. Thus, if the decision maker totally disregards the contractual clauses or default rules chosen by the parties, in ascertaining the specific contractual rights, obligations and risks, or in exercising abstract reasoning on the basis of his specialization to resolve the disputes over the allocation of residual rights, obligations and risks, the resulting decision would be in excess of the scope of the parties' delegation to the decision maker of controlling legal uncertainty, and become invalid.

The basic principle of sanctity of contracts requires the decision maker to ascertain the meaning of the articulated rules through interpretation in order to reveal the law between the parties and to enforce the specific contractual rights, obligations and risk allocations. This principle, as a requirement for international commerce, is a distinct rule from national laws, and dictates that violation of the articulated rules will have consequences, unless it is excused under certain circumstances. Under lex mercatoria, the principle of sanctity of contract is mainly a presumption leaning against the existence of any right of unilateral termination or modification of the contract by the parties. In principle, modification or termination of the contract should be allowed by the mutual subsequent agreement of the parties to that effect.

Such an agreement can be explicit or tacit depending on the circumstances of the case. Modification or termination without subsequent agreement can be admitted only when it is in conformity with the articulated rules, or on the basis of the qualifying function of the basic principle of good faith and fair dealing.

While the parties' consent to be legally bound is a necessary condition of the contractual rights and obligations, the basic principles of freedom of contract and sanctity of contracts not only denote the binding force of specific allocations of contractual rights, obligations and risks that have been made by the contracting parties through contractual clauses and the chosen set of default rules, but they also relate to the consent to the jurisdiction of some adjudication and enforcement mechanism, as a result of the alternatives available to the parties in the order of international commerce. Thus, in the order of international commerce, not only the articulated rules, but also the established rules constitute the law between the parties, who have manifested their consent to be legally bound by a particular contract and by the ex post decisions that resolve the disputes arising from that contract. By invoking the system of legal enforcement, the parties accept they are bound by both articulated and established rules in the particular case.

In this context, the basic principle of good faith and fair dealing under *lex mercatoria* implies the binding force of residual allocations of contractual rights, obligations and risks within the scope of the relevant contract, which will be determined by the ex post decision maker through the established rules. The principle requires the contracting parties to take into account the knowledge and interests of the elements of the legal order in which they operate, so as to enable the correspondence of their expectations with those of other elements of the order, on which the parties' plans are based. Under the basic principle of good faith and fair dealing, by becoming part of the contracting parties' cost of enabling the correspondence of expectations in the order, the knowledge of the established rules is brought to bear on the allocational ex post decision with regard to the residual contractual rights, obligations and risks. The contracting parties are compelled to take that knowledge into account, even if they do not have actually direct access to the necessary knowledge, provided that it is possible for the parties to be in a position to adapt their conduct to their ignorance of such knowledge through abstractions. Accordingly, the principle of good faith and fair dealing requires the ex post decision maker to mentally reconstruct this tacit knowledge of the parties through a contextual approach in the interpretation, supplementation and the correction of the articulated rules, and to tell them what ought to have guided their expectations by revealing the established rules in the particular circumstances, which they ought to have known and which become applicable as a result of the conclusion of their particular contract.

The basic principle of good faith and fair dealing is the substantive framework for principled adjudication and qualifies the basic principles of freedom of contract and sanctity of contracts. Therefore, the principle of good faith and fair dealing is the main means for the decision maker applying *lex mercatoria* to give effect to those expectations, which should be protected in order to maximize the fulfillment of expectations of the elements of the spontaneous order of international commerce as a whole. The principle of good faith and fair dealing requires the decision maker to exercise an abstract reasoning in specialized consolidations in order to decide in a manner which will correspond to what the reasonable people of the same kind as the actual parties would have expected in the same circumstances. It requires the decision maker to give effect to the reasonable expectations of the parties by explicitly referring to the subjective aspects of the contractual relationship, such as its purpose, nature, and internal context, in combination with the established rules in a particular case, which are derived on

the basis of an abstract reasoning through the specialized consolidations of national laws, trade usages or contracting practices, and a balancing exercise of various interests of elements of the order of international commerce involved in a particular case. Particularly, under the principle of good faith and fair dealing, the decision maker cannot tolerate the situations where the enforcement of the contract results in the violation of the public policy forming a part of parties' reasonable expectations through a balancing of relevant interests of the elements of the order of international commerce.

The basic principles of *lex mercatoria* include some procedural safeguards arising from the public policy considerations and the mandate of the decision maker in the context of international arbitration. Those safeguards ensure the meaningful utilization of the knowledge of particular circumstances of time and place, and the accuracy in giving effect to the reasonable expectations of the parties in a particular case. The procedural safeguards include the prohibition of fraud, corruption or perjured evidence, and the principle of due process, which mainly consists of the parties' rights to a reasonable opportunity to be heard and to equal treatment. The right to an equal opportunity for presentation of one's case implies the decision makers' duty to provide an equal opportunity for the parties to comment on the legal considerations. Thus, in discovering the established rules and ascertaining the articulated rules that are applicable in a particular case, the decision maker applying *lex mercatoria* should submit the relevant materials to the parties for their comments and arguments prior to rendering a final decision, and refrain from rendering such a decision, which both parties may be surprised by the legal reasons put forward. The decision maker, who incorporates into the final decision such rules not argued and expected by the parties runs, the risk of exceeding his mandate, unless the application of the relevant rule is prescribed by the agreement or terms of reference, or it is so general that it must be considered to be implicitly included in the pleadings of the parties. The decision maker's duty to comply with his mandate, in most cases, also includes his duty to render a reasoned award. This duty is particularly important for the decision maker applying *lex mercatoria*, who consolidates various materials by exercising his abstract reasoning, since it prevents the decision maker from pronouncing any rule he likes, and reduces the possibility of arbitrariness in the exercise of his specialization.

On the basis of these basic principles, *lex mercatoria*, as the law of principled adjudication, is applicable not only to the substance of the disputes, but also to the choice of law analyses of the decision maker. In the choice of law analyses, *lex mercatoria* may serve as a *lex fori* for the international arbitral tribunals and address the specific difficulties relating to the conflict of laws in the context of international arbitration, such as lack of proof of the relevant rule in the applicable law, the interpretation of a rule of the applicable law, a gap in the applicable law, the problems of interpretation of the intentions of the parties as to the applicable law. There are four possible situations in the choice of law analyses, where *lex mercatoria* can be applied in international arbitration as *lex fori* for giving effect to the reasonable expectations of the parties.

First, where parties have expressly selected a national law to govern the substance of the dispute, which is the most common scenario in the context of international arbitration, the decision maker should apply the chosen national law as a part of the bargain underlying the contract, pursuant to the basic principles of freedom of contract and *pacta sunt servanda*. In the abstract reasoning of the decision maker applying *lex mercatoria*, the contracting parties can be presumed to have diligently investigated, before entering into the contract, the contents of the national law of their choice, and have assumed the legal risks arising from the application of its rules. Thus, once the parties agree on an identifiable set of national rules,

those become part of the bargain that was contemplated under the contract, and the parties or the decision maker cannot refer to materials other than the contract and the chosen default rules, in contravention to the basic principles of *lex mercatoria*, in order to reallocate those risks that have already been assumed by the parties under those rules. Thus, the rules of the chosen national law can be overridden mainly by the contractual clauses, which are to be ascertained by interpretation, or by the implied intentions of the parties through specific supplementation, in accordance with the chosen national law.

The decision maker applying *lex mercatoria* is bound to apply even the idiosyncratic rules in the chosen national law, as part of the bargain contemplated under the contract between the parties when they are clear and not overridden explicitly or implicitly by the terms of the contract, or by trade usages, in the sense of commercial practices observed in a certain sector over a sufficient period of time. Trade usages in this narrow sense add a layer of contractual relationship in question rather than defeat a choice of national law by the parties. In determining the relevance of such trade usages to the resolution of disputes, the decision maker should refer to the specific rules on trade usages that can be found in arbitration laws and rules, rather than the requirements of the chosen national law in this regard. The decision makers may also refer to the broader understanding of trade usages, or the general principles of law, which corresponds to the concept of the established rules in the order of international commerce, when they are in conformity with the chosen national law, in order to accommodate the pleadings of both parties, by showing that the relevant national rule is an established one, and to underline that they are not an organ of a national legal system, by involving into their legal reasoning such materials that may not be considered as important and appropriate in the application of the national law by the authorities in the relevant legal system. However, when the chosen national law is clear on the disputed issue, the decision maker should not allow a party to escape from the resulting specific contractual obligations on the basis of the broader understanding of trade usages or other conceptions of the general principles of law in contravention to the basic principle of *pacta sunt servanda*. In such cases, in order to deviate from the specific rules of the chosen national law, the decision maker should only rely on the explicit or implicit intentions of the parties or trade usages in the narrow sense, which add a layer to the contractual relationship.

Where the parties agree on a national law as applicable to the contract, *lex mercatoria* in the interpretation and supplementation of the articulated rules will be relevant, when both the relevant contractual clause and the rule of chosen national law are ambiguous, and when there is a gap in both the contract and the chosen national law, which gives rise to the questions of residual allocation of contractual rights, obligations and risks. When the chosen national law is ambiguous or it does not cover the contingency that has become the disputed issue, the decision makers should resort to *lex mercatoria* in order to give effect to the reasonable expectations of the parties in a particular case thereby preserving or restoring the spontaneous order of international commerce, rather than attempting to act as an organ of the relevant national legal system, given that their decisions will neither be relevant to the development of that system, nor in any way contribute to the self-referential structures of that legal system. However, only after getting the chosen national law right on the basis of a legal research to be conducted in cooperation with the parties, and concluding that the chosen national law does not cover the disputed issue or recognizes a margin of discretionary power, the decision maker should resort to *lex mercatoria* in giving effect to the reasonable expectations of the parties.

Secondly, where the parties have agreed to the application of *lex mercatoria*, if unaccompanied by a particular national law in the choice of law clauses, the decision maker should interpret this clause to the effect that no particular national law indicates the reasonable expectations of the parties and should become part of the bargain contemplated under the contract. Thus, the decision maker should not engage into any form of choice of law analyses. Such clauses allow the decision maker to apply *lex mercatoria* and exercise his abstract reasoning in the specialized consolidations with regard to the merits of the dispute to the exclusion of any particular national law. When the choice of a national law is combined with the choice of *lex mercatoria*, the decision maker should carefully analyze the intention of the parties as to the extent of the incorporation of the chosen national law into the agreed bargain under the contract and its consideration as the articulated rules. The reference to the national law in such choices should not be rendered meaningless, while the decision maker should not treat the rules of the national law as incorporated into the agreed bargain under the contract, to the extent that they reflect the isolated position of the relevant legal system in the order of international commerce.

In those cases, the decision maker should take into account the intentions of the parties as to how the decision maker applying *lex mercatoria* should consolidate the relevant materials through his abstract reasoning in giving effect to their reasonable expectations. Such intentions must take precedence, pursuant to the basic principle of freedom of contract. They may include a specified hierarchy between various sources, or instructions as to the applicable legal norms. For instance, in the context of cases governed by the second sentence of Article 42(1) of the ICSID convention, since the reference is made merely to “international law” in addition to the law of the host state, the rules and principles of host state law should be applied by the decision maker to the extent that they are not in violation of the transnational public policy, or international law is not sufficiently clear to cover the lacunae in the host state law, in order to avoid subjective judgments and arbitrary decisions as to the position of international law in relation to the disputed issue. Nevertheless, even if the international law is unclear on the relevant issue, the decision maker should apply the principles of host state law to fill the lacunae in the host state law, by consolidating them with the general principles of law as a source of international law and *lex mercatoria*, in order to avoid speculations about how the national court of that legal system would decide the issue.

Thirdly, where the parties have not agreed on an applicable law, the application of *lex mercatoria* at the conflict of laws stage requires the decision maker to search for the established rules of conflict by means of indirect choice methods. There are two indirect methods: (1) cumulative application of the rules of conflict of laws of the national laws related to the dispute, and (2) recourse to general principles of conflict of laws. The indirect methods necessarily result in the application of a national law to the substance of the dispute. By means of indirect methods, the decision maker will determine the national law that is designated by the established rules of conflict as the applicable law and act on the presumption that the individual provisions of that national law indicate the reasonable expectations of the parties in the context of a particular transaction. This presumption may be rebutted when those provisions are in conflict with the express or implied intentions of the parties, which will be determined through interpretation and supplementation according to the basic principles of *lex mercatoria*, or when those rules reflect the isolated position of the authorities in the relevant national legal system and, no longer, indicate the reasonable expectations of the parties to a particular contract. In the latter case, those provisions may be overridden by the established rules in the order of international commerce since, in the absence of an express choice, it is not possible to consider those national rules as part of the

bargain contemplated under the contract. The decision maker may also fill in any lacunae in the applicable national laws by applying *lex mercatoria*, as the law of principled adjudication.

However, in order to disregard a national rule, which is found to be applicable pursuant to an established rule of conflict, for being idiosyncratic, the decision maker should at least be able to discover an established rule in the order of international commerce. There are many areas of law where the approaches of national legal systems diverge significantly. If the decision maker in a particular case confronts such a divergence among the national laws that are considered in the specialized consolidations to discover an established rule, the relevant rules of the applicable national law cannot be disregarded by the decision maker on the ground that those rules are idiosyncratic, since such a decision would be arbitrary: it would reflect the subjective reasoning of the decision maker about the expectations of the parties, despite the availability of objective considerations through the established rules of conflict. The decision maker should only consider itself competent to resort to its subjective reasoning in controlling the legal uncertainty arising from such divergences, where there are no established rules of conflict that designate a national law, or where the parties intended to avoid the application of any particular national law, i.e. in the cases of the application of *lex mercatoria* to the substance of the dispute to the exclusion of any particular national law.

The decision maker may resort to the direct choice method, when a satisfactory solution cannot be found through the indirect methods. The materials that can be utilized by the decision maker, resorting to the direct choice method in the search for established rules of conflict, are not limited to the conflict of laws rules of the national legal systems, but include the context of the contract and the relevant contracting or arbitral practices. Unlike the indirect methods, the direct choice method can be completely free of the constraints of the national conflict of law regimes. However, under the basic principles of *lex mercatoria* as the law of principled adjudication, the decision maker is not liberated from the duty to give a reasoned award, which implies that reasons should be stated for choosing the substantive law in question even if the choice seems obvious to the decision maker. The decision maker should not rely on the direct choice method without an attempt to demonstrate to the parties that they could not reasonably expect the application of any law other than the one finally determined. In contrast to the indirect methods, the determination of the applicable law through direct method may lead to the application of a national law and/or *lex mercatoria* to the substance of the dispute and, thus, raise the questions of *lex mercatoria* as the substantive law exclusively governing the dispute. Under the direct choice method, the context and contents of a particular contract are the main factors determining in which manner *lex mercatoria* should govern the substance of the dispute in the absence of choice of law by the parties. However, in most cases, a mere absence of choice of law should not lead to the exclusive application of *lex mercatoria* to the substance of the dispute by means of the direct choice method.

When there is an established rule of conflict designating a particular national law as applicable, and in the absence of indications that enable the recourse to direct choice method, the application of *lex mercatoria* to the exclusion of any particular national law depends on the implied common intention of the parties to avoid the ex post consideration of the rules of any particular national law as indicating their reasonable expectations: in other words, the decision maker should find an implied negative choice of national laws, for the exclusive application of *lex mercatoria* in those cases. The decision maker applying *lex mercatoria*, as the law of principled adjudication, should carefully interpret the contractual intentions of the parties through a contextual approach as required by the basic principle of good faith and fair

dealing in order to decide whether or not he should apply *lex mercatoria* exclusively. In such an interpretation, the parties' history of negotiations and their pleadings with respect to the applicable law during the proceedings are mainly the determinant factors that should be taken into account by the decision maker in deciding on this issue. However, the decision maker should not act solely on the basis of the consideration that each party invoking the application of its own national law in the proceedings indicates that the application of national law of one of the parties would disturb the equilibrium established under the bargain between the parties. Any rule that is applied *ex post* by the decision maker may potentially affect the initial bargain, regardless of whether it is a general principle of law or a rule of the national law of either party. The rules that can be considered appropriate for a particular bargain should merely reflect the reasonable expectations of the parties in the particular case. Thus, the decision maker should not hesitate to apply one of the national laws of the parties when it is applicable pursuant to an established rule of conflict.

While the exclusive application of *lex mercatoria* should not be based on the mere fact that each party pleads the application of its own national law in the proceedings, the explicit or implicit intentions of the parties as to the neutrality of the applicable substantive law may indicate an implied negative choice of the national laws, and lead to the exclusive application of *lex mercatoria* to the substance of the dispute, due to the speculative nature of designating a third country law as the neutral law. Moreover, in a situation where there is evidence of the intentions of the parties as to the exclusion of the national laws of the parties, and where one of those laws could be designated to be applicable by the established rules of conflict, the decision maker should not reject the exclusive application of *lex mercatoria* to the substance of the dispute, without considering whether the application of the designated national law would amount to holding one of the parties to a bargain, which he specifically attempted to avoid and managed to persuade the other party to defer the issue until the time of dispute for a more satisfactory solution. In such a situation, the decision maker may interpret, in accordance with the basic principle of good faith and fair dealing, the absence of choice to the effect that parties have agreed to exclude the application of any given national law, including even that of a third, neutral country, while being unable to agree on any satisfactory alternative or positive formula.

Fourthly, where the decision maker has been authorized by the parties to act as *amiable compositeur* or to decide *ex aequo et bono*, *lex mercatoria* can be relevant to the decision maker's considerations of equity and help him to deliver a reasoned award that accurately gives effect to the reasonable expectations of the parties in a particular case. The distinction between *lex mercatoria* on the one hand and the *amiable compositeur* and the arbitration in equity on the other has been problematic in the doctrine. Such a distinction can be made on the basis that decision makers, in the latter cases, can resort entirely to their sense of equity which is a form of abstract reasoning, without consolidating any materials, in giving effect to the reasonable expectations of the parties. Thus, *amiable composition* and arbitration in equity denote a wider delegation by the parties to the specialized decision maker in the control of legal uncertainty. While *lex mercatoria* would involve the application of the established rules in a particular case that should be discovered by means of the specialized consolidations of the decision maker exercising an abstract reasoning, *amiable composition* or arbitration *ex aequo et bono* would authorize arbitrators to depart from any established rule and to look to the fairness of their decision on the basis of a purely abstract reasoning. Thus, a decision maker's capacity to act as *amiable compositeur* or to decide *ex aequo et bono* give implies a decision on the basis of "absolute equity" and the power to act *contra legem*, through abstract reasoning and without any specialized consolidations, when the enforcement of articulated or

established rules lead to an inequitable result according to the sense of equity of the decision maker.

Lex mercatoria has still relevance to those decision makers empowered to act as amiable compositeurs or to decide *ex aequo et bono*, through public policy considerations and procedural safeguards, particularly pursuant to the duty to give a reasoned award. Moreover, the basic principle of sanctity of contracts under lex mercatoria should also be inherent to the equity considerations of such decision makers, even if they understand that equity in the sense of *contra legem* allows them to disregard the contract terms. Thus, in order to depart from the contract terms, the decision makers acting as amiable compositeurs or deciding *ex aequo et bono*, rather than entirely relying on equity *contra legem*, may consider the basic principle of good faith and fair dealing under lex mercatoria thereby drawing inspiration from such established rules as *rebus sic stantibus* or abuse of rights. Although, the amiable compositeurs or arbitrators in equity are not obliged to discover and apply the established rules in a particular case, their reasoning can be more accurate in giving effect to the reasonable expectations of the parties, if they reveal some abstract connections between the facts and the established rules, in explicating their analyses as to why they should disregard or adjust the contractual clauses, since such an approach may allow the parties to the dispute to comment on the reasoning of the decision makers, and better serve the procedural integrity of the proceedings by enabling the cooperation of the parties for the purposes of accurate determination and giving effect to their reasonable expectations. Therefore, although amiable composition or *ex aequo et bono* implies the possibility of equity *contra legem*, a reasoning that draws some inspiration from lex mercatoria as the law of principled adjudication may result in a more objective and accurate decision.

The application of lex mercatoria to the substance of the dispute denotes three activities of the decision maker: interpretation, supplementation and correction of the contract. In these activities, the reasonable expectations of the parties to a particular contract become the single source of their contractual rights, obligations and risk allocations. Thus, when interpreting or supplementing the contract through a contextual approach or intervening in the contract on the basis of public policy considerations, the decision maker applying lex mercatoria interprets, supplements and corrects not only the terms of the contract, but also the national laws applicable to the contract, in the process, not for the purpose of the development of the particular national legal systems, but for maximizing the possibility of expectations of the elements of the order being fulfilled, matched and not conflicting, in accordance with the basic principles of lex mercatoria.

Under lex mercatoria, the decision maker interprets the contract through a contextual approach under the guidance of the basic principles in order to determine and ascertain its meaning and to enforce the specific contractual rights, obligations and risk allocations of the parties. The basic principle of freedom of contract requires that the primary object of interpretation is giving effect to the common intention of the parties. However, where the contract contains clear and express provisions, those provisions should be respected and enforced in their natural meaning. Any consideration of reasonable expectations on the basis of specialized consolidations, which may transform the ascertainable meaning of the contract on the basis of its text into a factor of secondary importance, is contrary to the basic principle of sanctity of contracts under lex mercatoria. In determining to what extent the evidence relating to the common intentions of the parties that indicates a divergence from the plain meaning of the text is admissible, the decision maker should act on the view that, in availing themselves of the faculty of entering into a contract, the parties intend to pursue a purpose

which, in accordance with the basic principles of *lex mercatoria*, the contract must be considered to fulfill. The principle of good faith and fair dealing implies that if a party attempts to abuse that faculty by relying on the plain meaning of the contract thereby reducing it to the level of a device to act opportunistically and dishonestly during adjudication and to gain benefits not arising from that purpose, he cannot rule out the contingency that the decision maker will adopt a contextual approach to the interpretation in order to reflect the common intentions of the parties.

Under the contextual approach of *lex mercatoria*, the decision maker should first resort to the internal context of the contract by considering the text of the contract as whole together with its nature and purpose. Since the nature and purpose of the contract, in some cases, can only be determined on the basis of external context of the contract and, thus, they may relate to both subjective and objective considerations, the focus on the nature and purpose of legal arrangements should generally prevail in all stages of interpretation of contract under *lex mercatoria*. If the meaning may not be ascertained solely on the basis of internal context of the contract, the recognition of the significance of the individual case and the knowledge of particular circumstances of time and place under *lex mercatoria* should require the priority of the extrinsic evidence relating to the subjective considerations, such as preliminary negotiations between the parties, practices which the parties have established between themselves, and the conduct of the parties subsequent to the conclusion of the contract. The established rules of interpretation in the order of international commerce allow the decision maker to take into account the evidence of such considerations in the interpretation of the contract and, thus, those established rules may supersede the idiosyncratic rules of national laws, when they are applicable pursuant to the established rules of conflict. On the other hand, the use of extrinsic evidence relating to subjective considerations in the interpretation of contract may be barred by the parties with explicit contractual clauses, or by their choice of default rules, or as a result of their common intentions determined through a contextual approach, to the extent that their enforcement in the particular circumstances of the case does not result in a violation of the basic principle of good faith and fair dealing.

Where the decision maker cannot determine the common intentions of the parties solely on the basis of the subjective considerations, he should resort to the objective considerations and combine them with the text, nature and purpose of the contract as a whole, and extraneous factors relating to subjective elements, to the extent that they are available, in order to ascertain the specific contractual rights, obligations and risk allocations. Such objective considerations will mostly be characterized by the reasonableness test of the decision maker. This test enables the decision maker to exercise an abstract reasoning about the tacit knowledge of a party and to use imperfect knowledge creatively through his specialization, in the context of the heterogeneous society of the order of international commerce. When there is still doubt with regard to the common intentions of the parties and the use of extrinsic factors and reasonableness test does not provide conclusive results about the meaning to be attached to the terms of contract in dispute, the decision maker may resort to the interpretative presumptions in the form of established rules, which aid the interpretation of the contract.

Under *lex mercatoria*, when there are some contingencies that are not covered by the ascertainable meaning of the contract, the decision maker supplements the contract with implied terms, which prevail over the default rules that are chosen by the parties or found to be applicable by means of the established rules of conflict. The decision makers applying *lex mercatoria* do not have to follow the requirements of the national legal systems for the supplementation of the contract on the basis of the implied intentions of the parties, but may

search for established rules that guide them in supplementing the contract with individualized terms, unless the national law chosen by the parties imposes such requirements, which the decision makers then have to apply as articulated rules and part of the bargain. In the supplementation of the contract with individualized terms, the activity of the decision maker shifts from the ascertainment of the meaning of the contract to the ascertainment of the content of contract. Such terms may precede all forms of default rules that address the generality of actions, regardless of whether they are applicable as established rules or on the basis of the choice of law analyses.

In the supplementation of the contract with individualized terms under *lex mercatoria*, the decision maker will consider the relevant materials that indicate the reasonable expectations of the parties within the internal and external context of the contract. This activity can be conceived as extending the contextual approach, which governs the interpretation of the contract, to the supplementation of contract on the basis of the same materials that are related to the reasonable expectations of the parties to a particular dispute. Thus, the contextual approach is a characteristic of *lex mercatoria*, as the law of principled adjudication, which is based on the idea of meaningful utilization of the knowledge of particular circumstances of time and place. In this regard, trade usages in the narrow sense are another means for the supplementation of the contract under *lex mercatoria* in a manner that precedes the application of the default rules, which are chosen by the parties or found to be applicable by means of the established rules of conflict. The particular provisions in the arbitration rules and laws, which require that arbitrators consider trade usages, underline the objective of providing international commercial disputes in a manner which accords with commercial expectations and practices and release the arbitrators from the requirements for the relevance of trade usages established by the national legal systems, even if a national law is chosen by the parties to govern the substance of the dispute. Since those provisions do not guide the arbitrators as to which practices constitute trade usages in the narrow sense, the decision maker applying *lex mercatoria* may consider the CISG and the international restatements of contract principles as reflecting the established rules under *lex mercatoria* for determining the relevance of such trade usages, which supplement the contract and even prevail over the default rules of a national law chosen by the parties as the applicable law.

Thus, the materials indicating the reasonable expectations of the parties, for the purposes of supplementation of the contract with implied terms under *lex mercatoria*, include the nature and purpose of the contract, prior negotiations, subsequent conduct of the parties, course of dealing established between the parties, trade usages in the narrow sense, and the abstract reasoning of the decision maker with regard to the test of reasonableness. The parties may prevent the decision maker from using certain extrinsic factors to supplement the contract, through contractual clauses or their choice of default rules, in accordance with basic principle of freedom of contract. However, those contractual preferences cannot eliminate entirely the effect of basic principles of *lex mercatoria*. The parties cannot oust the process of contextual approach of the decision maker utilizing all sorts of factors and his specialization, which are based on the basic principle of good faith and fair dealing, if the actions of one of the parties at the enforcement stage amounts to the abuse of contractual rights. The clauses or the chosen default rules, which limit the relevance of extrinsic factors in the supplementation of the contract under *lex mercatoria*, may then operate as a presumption which increases the burden of proof for the party attempting to refute.

Under *lex mercatoria*, the decision maker intervenes in the contract and determines the limits of the principle of freedom of contract in the order of international commerce on the basis of

the established rules. *Lex mercatoria* enables such an intervention without impairing the confidence of the elements of the order of international commerce in the specialization of the decision maker in dealing with the legal uncertainty. In the order of international commerce, except for the limited and uncertain contents of the transnational public policy, there are no directly and effectively applicable legal structures, that limit the freedom of contract of the parties, and become immanently binding for the decision makers to carry out a mandate, as an organ of a legal system, with regard to the enforceability of a contractual term. Thus, in this context, it is almost impossible to make a clear distinction between the concepts of public policy and mandatory rules. Under *lex mercatoria*, a mandatory rule or standard that limit the parties' freedom of contract can be described as those reflecting a public policy interest so commanding that its violation cannot be tolerated in the context of peaceful development of international commerce, and it may be applied even if the contract provides otherwise and the general body of law to which such a rule or standard belongs is not competent by application pursuant to the parties' choice or the conflict of laws rules in the absence of choice.

Lex mercatoria requires the decision maker to determine the conditions of illegality in the international contracts in a manner which maximizes the possibility of correspondence of expectations in the order of international commerce. Thus, the decision maker applying *lex mercatoria* should search for some form of correspondence between the actions that are taken by various national legal systems for the purpose of protecting their internal orders or the order of international commerce, which can be considered as having permeated the knowledge and expectations of the parties and become a source of *lex mercatoria* under the basic principle of good faith and fair dealing. The capacity of the decision maker applying *lex mercatoria* in searching for such a correspondence that potentially influences the characterization of the reasonable expectations of the parties can be based on an established rule of private international law that certain mandatory national laws may qualify as overriding or international mandatory rules and apply notwithstanding the parties' choice of law. An established rule on this issue can be derived from the cumulative application of such rules under the private international laws of the countries relevant to the dispute, or a general principle of law relating to the overriding applicability of international mandatory rules. This established rule is not only relevant to the determination of the applicability of the "foreign" mandatory rules, but also to that of the mandatory rules of the national law chosen by the parties to the extent they contradict with the terms or purpose of the contract, since all mandatory rules of concerned national legal systems have the same value and rank on the same level for the decision maker applying *lex mercatoria*.

This established rule enables a balancing exercise, which can be made in a particular case on the basis of an abstract consideration of the mandatory rules and public policy standards of the legal systems of the countries, where the award is made, where the contract is performed, of which the parties are citizens and alike. In this balancing exercise, the decision maker should initially consider whether the relevant mandatory rule or standard is within the expectations of the parties as to its applicability thereby taking into account the interests of the parties in the enforcement of their contract. The decision maker should consider the extent of the transaction's connection with the national legal systems containing mandatory rules or public policy standards relevant to the case. The strength of this connection indicates that illegality can be treated as an issue of risk allocation, to the extent that both parties can be considered as aware of it when entering into the transaction. Thus, the closer the contact to the national legal system enacting the mandatory rule or claiming a public policy value, the more relevant will be the protected interest to the decision maker's consideration for intervention in the articulated rules. This is because such an interest will be influential on the considerations of

reasonable expectations of the parties, and because the violation of that rule or value will more likely have the expected detrimental consequences in the relevant internal order.

Subsequently, the decision maker should consider the expectations within the state having enacted the relevant norm thereby taking into account the interest of the internal order of the relevant legal system against the enforcement of the contract. The decision maker should take into account both whether the mandatory rule or public policy standard being considered is an international one from the perspective of the state enacting it, and whether the application of the international mandatory rule or public policy standard, in respect of the issue at stake, is consistent with the established rules of policy in the order of international commerce. In this regard, to the extent that the interests to be protected by the mandatory rule or public policy standard claiming application are more uniformly recognized as worthy of protection by the national legal systems relevant to the dispute, the decision maker will more readily intervene by applying such rule or standard and giving precedence to that over the contract and its applicable substantive law.

The correspondence of the national legal systems on the understanding of an activity as a violation of mandatory rules or public policy standards should be sought in the protected interest, but not in the method adopted by the protecting rule or standard, which might significantly vary in different national legal systems due to the diverse nature of their internal orders. As long as the relevant interest is protected by the established rules of policy and there is sufficient connection between the contract and the national legal system, the particular method adopted by the authorities in that national legal system should be presumed to further such interests and enforced by the decision maker, given that those authorities are in a better position to obtain the necessary knowledge for the regulation of their internal orders. The particular method adopted by a national legal system for furthering the interests protected by the established rules of policy may be disregarded by the decision maker applying *lex mercatoria*, if its enforcement results in a violation of the contents of transnational public policy. In this regard, the decision maker should consider the transnational public policy in a negative sense to determine whether the relevant mandatory rules, although sufficiently connected to the contract, would violate fundamental moral or ethical principles or universally recognized human rights, or universally accepted public international law principles. The considerations of transnational public policy may also have a positive meaning thereby affirmatively and directly imposing the application of certain principles prohibiting certain activities, such as bribery or smuggling, or commanding specific solutions, such as where a state relies on its own law to evade from its contractual obligations towards a private party. Thus, even if the mandatory rule or public policy standard of the relevant national legal system does not qualify for the intervention under the balancing exercise, the decision maker applying *lex mercatoria* should weigh the facts of the case in the light of the concept of transnational public policy in a positive sense, before finally deciding whether or not to intervene in the contract.

The considerations of transnational public policy are not issues of moral or political choice of the decision maker. The concept of transnational public policy should not be resorted to in a manner that disrupts the peaceful development of the spontaneous order of international commerce. Essentially, the transnational public policy requires respect for the knowledge and capacity of the authorities in national legal systems for regulating their internal orders, and it can be considered as an interest protected by the established rules of policy that *ex post* judicial processes should not become a means for disturbing such orders that are directly and clearly affected by a particular transaction. Thus, the decision maker applying *lex mercatoria*

should take into account that there is a universally recognized interest for the general protection of the public in a state, that the authorities in national legal systems are in a better position to regulate the actions of the elements of their internal orders, and that the methods adopted by those regulations should be respected to the extent that their underlying interests are protected by the established rules of policy, when an international contract is closely connected to the jurisdiction enacting the relevant rule or standard. These considerations imply that, on the one hand, absolute and unlimited freedom for the parties to regulate their transactions is not a part of transnational public policy in the order of international commerce and, on the other hand, the deliberate actions of authorities in the national legal systems that are taken for the restoration or improvement of their internal orders or the order of international commerce should not destroy the balance, but respect the abstract relations constituting the order of international commerce and the possibility of the correspondence of the expectations of its elements without any conflict.

The consequences of intervention of the decision maker in the contract should, in principle, be governed by the method prescribed under the mandatory rule or public policy standard, which has been found to be applicable under *lex mercatoria*. In this regard, the decision maker should consider the possibility of partial illegality, and exercise his abstract reasoning as to the applicability of mandatory rules or public policy standards, to ascertain the specific aspects of the contract he considers to be contrary to relevant public policy considerations. Where the consequences of illegality are not expressly prescribed by the applicable mandatory rule or public policy standard, such as the contents of transnational public policy, the decision maker may extend the exercise of balancing the relevant interests to the determination of the consequences of the found instances of illegality. In such cases, to account for the particularities, the decision maker may resort to the restitutionary remedies. However, restitution in cases of illegality should be available to the extent the applicable mandatory rule or public policy standard does not deny it. Thus, only where the denial of restitution is not explicit or implicit in the sense of a necessity to discourage certain activities in the order of international commerce, the decision maker applying *lex mercatoria* can extend his abstract reasoning in the determination of the conditions of illegality to the determination of the restitutionary consequences of the found instances of illegality.

By means of the activities of interpretation, supplementation and intervention, the decision maker applying *lex mercatoria* reveals and enforces the law between the parties to a particular contract, which includes the articulated and established rules. The application of *lex mercatoria* to the substance of the dispute enables the decision maker to accurately give effect to the reasonable expectations of the parties to a particular case by exercising an abstract reasoning in the specialized consolidations to find those established rules, without being bound by the formal consolidations under the national legal systems, unless they are incorporated by the parties into the articulated rules through a choice of law clause, or they indicate the reasonable expectations of the parties in a particular case pursuant to the established rules of conflict, in such areas of law where the approaches of national legal systems diverge significantly. While the materials subject to the specialized consolidations of the decision maker vary from case to case, the element of abstract reasoning in the specialized consolidations should always follow the abstract relations constituting the spontaneous order of international commerce in order to maximize the possibility of expectations of the elements of the order being fulfilled, matched and not conflicting.

The dissertation has identified three sources for abstractions that should motivate the reasoning of the decision maker in reconstructing the tacit knowledge of the parties and in

applying to the substance of the dispute whatever rules or standards of contractual, national or transnational origin. These sources are national contract laws, international instruments relating to international commercial contracts, and contracting practices in the order of international commerce. The abstractions from these sources usually, but not necessarily, indicate the established rules in the order of international commerce. Even if the decision maker cannot articulate an established rule in the order of international commerce through such abstractions, the abstract reasoning is still important since it constitutes the background for the decision making on the basis of the application of *lex mercatoria* to the substance of the dispute either as *lex fori* or *lex contractus*. Thus, the abstractions need not be articulated by the decision maker in the final award in each instance, but it should form the basis of specialized consolidations and the decision making under *lex mercatoria*. In the dissertation, the abstract reasoning and the principled decision making under *lex mercatoria* have been examined in relation to some selected issues that concern the substance of the disputes arising from international contracts: (i) duty of cooperation, (ii) duty to achieve a specific result and duty of best effort, (iii) force majeure, (iv) hardship, (v) right to terminate the contract, and (vi) damages for non-performance.

The duty to cooperate under *lex mercatoria* appears as a general implied term covering many instances of good faith duties, enabling the decision maker to exercise an abstract reasoning that forms the basis of his specialized consolidations about the required cooperative behavior of parties in a particular case. Where the parties may not be able to provide contractual clauses for each instance of required cooperation, the decision maker at the enforcement stage deals with the resulting legal uncertainty by supplementing the contract with such duties to cooperate that allocate the residual obligations in accordance with the underlying bargain and the established rules discovered through the principle of good faith and fair dealing. Those duties mainly arise from the standard of good faith in the default rules chosen by the parties and abstract considerations of the closer confidence generated between the parties throughout the contractual relationship, the successful performance of contractual obligations, and the purpose of the contract. However, the decision maker applying *lex mercatoria* should not solely rely on the abstract concept of good faith in supplementing the contract with various duties of cooperation, in a manner similar to an amiable compositeur or arbitrator in equity, which runs the risk of exceeding the scope of the parties' delegation to the decision maker of controlling legal uncertainty. In supplementing the contract with duties of cooperation, the decision maker applying *lex mercatoria* should adopt a contextual approach in evaluating the required behavior from the parties to a particular contract in order not to disturb the contractual equilibrium. The costs of the supplementing duty must be reasonable and appropriate for the underlying bargain, purpose and nature of the transaction, and the decision maker should take into account that the extent of a party's duty of cooperation may be limited by the other's corresponding duty of diligence in the particular circumstances of the case.

Under *lex mercatoria*, the consideration of the distinction between the duties to achieve a specific result and the duties of best effort may precede the liability regime of the default rules chosen by the parties or found to be applicable pursuant to the established rules of conflict, as a matter of interpretation of the contract or supplementation of it with individualized terms. The distinction enables the decision maker to determine the conditions of liability and burden of proof, through an accurate reflection of the reasonable expectations of the parties in a particular case. If the parties' reasonable expectations require the decision maker to characterize an articulated or residual obligation, as one of "best efforts", the promisee will have the burden of proving that the promisor has not satisfied the requirements of its obligation, so that the liability of the promisor may appear as fault-based, regardless of the

liability regime of the applicable default rules. In determining the degree of required efforts, the decision maker applying *lex mercatoria* should consider that, under a “best efforts” obligation, the promisor obtains some autonomy of judgment within the scope of its obligation. The promisee should prove that the promisor have failed in the exercise of this autonomy through incompetence or abuse, and the decision maker should examine the evidence relating to such a failure by taking into account the nature and purpose of the contract, as well as objective and subjective factors surrounding the contract through a contextual approach. Thus, the decision maker will focus on the degree of efforts as would be made by a reasonable person of the same kind in the same circumstances, while emphasizing the subjective competence of the promisor, contractual context and the pleadings of parties in giving practical substance to the required degree of efforts. If the decision maker interpreting or supplementing the contract concludes that the obligation breached is an undertaking to achieve a certain result, then the promisee will only have to prove that the result have not taken place, and the promisor will bear the risks relating to its failure to perform the obligation, as though he has strict liability since he may not plead that he had done his best, subject to whether the default rules chosen by the parties or applicable pursuant to the established rules of conflict provide a rebuttable presumption of fault.

Regardless of whether its undertaking is characterized as one of best efforts or achieving a certain result, the promisor may be excused from liability for its non-performance due to a force majeure event. The promisor invoking the excuse should prove that two basic requirements of the force majeure excuse have been fulfilled in the particular case, unless otherwise specifically provided by the parties in the terms of the contract or by the applicable default rules. Firstly, the alleged event of force majeure must prevent the promisor from performing any of its obligations in accordance with the underlying bargain. This requirement will usually depend on the existence of a legal, factual or physical impossibility in an objective sense. However, the subjective impossibility may also satisfy this basic requirement, where the contract strictly requires the promisor to perform its obligations personally or through its own organization, and the supervening event renders such performance impossible. Economic impossibility or impracticability may also excuse the non-performance of the contractual obligations on the basis of the articulated rules or the default rules applicable pursuant to the established rules of conflict. Secondly, the effect of the alleged event of force majeure on the contractual obligations must be outside of the control of the promisor. This requirement implies that the event must be both unforeseeable and unavoidable for the promisor. The determination of the existence of the unforeseeability and unavoidability depends on the contract and the presumptions about the parties’ competences, which will be determined on the basis of the test of reasonable persons of the same kind as the parties placed under the same circumstances, through the contextual approach of the decision maker. The decision maker applying *lex mercatoria* will presume that the promisor has or should have exercised the foresight expected from a reasonable person of the same kind in the same circumstances, and assumed the costs of such efforts as would be made by a reasonable person of the same kind in the same circumstances, to avoid the effect of the alleged event of force majeure on the performance of its obligations.

The decision maker applying *lex mercatoria* should approach the issues of force majeure as a matter of risk allocation between the parties. Thus, the basic requirements of force majeure excuse essentially determine whether or not there is a gap in the risk allocation under a particular bargain. If the promisor is prevented from performing by an event whose occurrence, according to the intentions or expectations of the parties, is at neither party’s risk, then there is a gap in the risk allocation. Thus, the force majeure excuse, when successfully

invoked by the promisor, requires the decision maker to allocate the relevant rights and obligations arising residually from such a gap on the basis of an abstract reasoning that takes into account the contractual clauses and the default rules, which are applicable as a result of the parties' choice or pursuant to the established rules of conflict. The force majeure excuse initially suspends the performance of the contractual obligation, unless the contractual clauses or the default rules chosen by the parties explicitly deny such a suspension. If a force majeure event is permanent in its duration or in its effects on the performance of obligations as agreed under the contract, then the contract will be terminated. In such cases, the force majeure releases both parties from their obligations to perform and receive future performance as of the date of termination, which will be determined by the decision maker.

In principle, the termination of the contract in cases of force majeure implies that "the loss lay where it fell". This result is subject to the decision maker's discretion to allocate any such losses in proportion to the extent the contract was performed by the date of termination in accordance with the underlying bargain, as long as the contract or the applicable default rules do not explicitly deny a restitutionary flexibility in cases of force majeure. Although the flexibility to apportion loss in consequence of force majeure excuse may be perceived as an instance of the impression of "splitting the difference" between the parties, such an allocational decision is almost necessarily an instance of the decision maker's exercise of equity *infra legem* arising from the applicable default rules or established rules in the particular case, and should not be motivated by an idea of satisfying both parties by giving them something, but relate to the decision makers' concern for reflecting accurately the reasonable expectations of the parties in such a residual allocation.

While the force majeure excuse requires the temporary or permanent impossibility to perform contractual obligations, the issue of hardship covers situations, which totally modify the economical balance of the contract into the future, and raises the question of a new agreement through renegotiation and adaptation. However, the conflicting approaches of the national legal systems and the great variety of the hardship clauses in the international contracting practices preclude the decision maker applying *lex mercatoria* to discover such established rules in the order of international commerce, which could constitute a doctrine of hardship. Nevertheless, the abstractions from the national legal systems and international restatements support the view that it is one of the concerns in the different approaches to the issue of hardship that the parties should resolve themselves through cooperation the problems arising from an unforeseeable contingency, which does not render the performance of the contract impossible, but disturbs the equilibrium of the contract by increasing the cost of performance. Such a concern is also appropriate in the spontaneous order of international commerce, due to the importance of the utilization of the knowledge of the particular circumstances of time and place, of which beneficial use can be made only if the decisions depending on it are left to the parties or are made with their active cooperation. Thus, the decision maker, applying *lex mercatoria*, should be willing to encourage and direct the parties to renegotiate for adjusting their contracts, in the change of circumstances, which render performance excessively onerous, by creating costs which have been neither contemplated nor allocated by the parties through the articulated rules. However, the unconditional acceptance of judicial adaptation in hardship cases may lead to a dangerous degree of discretionary power whereby the specific contractual rights and obligations of the parties come under the judicial review through the principle of good faith and fair dealing for the sole reason that the circumstances are materially modified and generate significant imbalance between the respective obligations of the parties.

Under *lex mercatoria*, before considering the adaptation in the contract due to unforeseen contingencies that make the performance excessively onerous, on the basis of the applicable default mechanisms, the decision maker should consider the possibility of making adjustments in the determination of the risk assessments. The decision maker may account for the incompleteness in the specification of the risks explicitly allocated by the parties in their narrow frame by adjusting the probability assessment of the more broadly framed risk on the basis of the test of reasonable persons of the same kind as the parties placed under the same circumstances. Thus, the examination of the issue of hardship under *lex mercatoria* should not start from the default mechanisms of the relevant doctrines. Only if there are no explicit or implicit indications as to the risk allocation agreed between the parties and the parties fail to agree on a solution through renegotiation, these risks must be allocated by the decision maker in such a way that upholds the underlying bargain and the reasonable expectations of the parties to a particular contract. In such cases, the decision maker should refer to the mechanisms provided by the terms of the contract, or the default rules chosen by the parties or applicable pursuant to the established rules of conflict. The issue of idiosyncrasy in the applicable national rules will not arise in this respect due to the divergence of approaches in the default mechanisms of the relevant doctrines. Those default mechanisms would eventually require the decision maker to adopt one of the three solutions: termination, preservation or adaptation of the original contract.

In this context, the decision maker's capacity to adapt the contract due to a hardship event should be derived from a contractual term, a trade usage in the narrow sense, or a national default rule applicable to the substance of the dispute. In cases where *lex mercatoria* governs the substance of the dispute to the exclusion of any national law, the solution of adaptation should be covered by either party's petitions or evidence, so that the issue comes under the scope of the parties' delegation to the decision maker of controlling legal uncertainty. In such cases, the decision maker should not adapt the contract to the change of circumstances, if neither party requests for adaptation, since the *ex officio* adaptation of the contract by the decision maker requires an authorization from the articulated or established rules in the particular case, but there is no established rule in the order of international commerce that grants such an authority to the decision maker unconditionally. Moreover, where a party requests for adaptation, but the decision maker is not given sufficient indications as to how the alternative terms should be determined, he may have to dismiss the claim for adaptation, and turn to determining the conditions of termination and its possible consequences. Thus, the decision maker applying *lex mercatoria* should not engage in an exercise of adaptation of the contract due to hardship in the absence of sufficient indications in the evidence of negotiations or the parties' pleadings as to the alternative terms, when *lex mercatoria* governs the substance of the dispute exclusively, or without having regard to the specific requirements of judicial adaptation, when the articulated or established rules in the particular case address the issue of hardship, since such an exercise of adaptation can be considered as an instance of equity *contra legem* and of splitting the difference, which may never serve the aim of accuracy in reflecting the reasonable expectations of the parties.

The parties' right to terminate the contract under *lex mercatoria* requires the decision maker to focus on the contract and the default rules chosen by the parties pursuant to the basic principles of freedom of contract and sanctity of contracts. To the extent there are gaps or standards in the articulated rules in relation to the specific issues of termination raised in the proceedings, the abstract reasoning of the decision maker should be motivated by the consideration that certain circumstances, whether it is non-performance of express or implied obligations, or another unforeseen or foreseen event, may justify the exercise of the right to

terminate the contract by a party, and affect the process of termination set out by the articulated rules, to the extent such a party cannot be reasonably expected to continue with the contractual relationship under such circumstances. Under *lex mercatoria*, the termination of contract is an inherent part of the contractual relationship and, thus, a matter of interpretation and supplementation of the contract. The decision maker applying *lex mercatoria* should determine through a contextual approach whether such circumstances have attained a sufficient degree of seriousness so as to enable a party to leave the bond of *pacta sunt servanda* and to terminate the contract without strictly following the process of termination set out by the articulated rules, by considering, at an abstract level, the international contracting practices of drafting termination clauses in terms of risk allocations, which provide a mixture of various termination grounds, and in terms of problem solutions, which incorporate such mechanisms as notice period, *Nachfrist* and cure by the non-performing party.

Under *lex mercatoria*, the termination of the contract has mainly a prospective effect, discharging the parties from their obligations of future performance, since transactions governed through legal uncertainty will usually arise from long-term contractual relationships, where imposing a retrospective regime of mutual restitution may be inappropriate or impossible. It is an established rule in the order of international commerce that the termination of contract does not preclude the aggrieved party from claiming damages for non-performance, or from invoking such contractual clauses that are intended to operate even after termination, unless termination has resulted from a gap in the risk allocation with regard to such unforeseen events that excused the non-performance. In cases where the decision maker is required to give effect to the retrospective effect of termination, the decision maker should examine the restitutionary consequences of termination within the context of the competing interests of the parties, and contractual risk allocations, which are to be determined and ascertained through interpretation or supplementation, to the extent that the decision maker is enabled to exercise his abstract reasoning on the basis of these considerations by the flexibility of the default rules that are applicable to the substance of the dispute, pursuant to the choice of the parties or the established rules of conflict.

The remedy of damages for non-performance under *lex mercatoria* is a substitutionary relief, which the aggrieved party may claim, either in conjunction with or as an alternative to its right to terminate the contract. The decision maker, applying *lex mercatoria*, may derive many established rules as to the issue of damages for non-performance in the order of international commerce from the national legal systems and international instruments, through the specialized consolidations on the basis of an abstract reasoning. In this regard, the first established rule in the order of international commerce is the principle of full compensation, which requires the decision maker to give effect to the expectation of the aggrieved party from the performance of the contract by putting it into as good a financial position as that in which it would have been if the contract had been duly performed. Unless required by the default rules chosen by the parties or determined as governing the contract by means of the application of *lex mercatoria* at the stage of conflict of laws, the decision maker applying *lex mercatoria* does not have to discuss the distinction made by the national legal systems between expectation (positive) interest and reliance (negative) interest, according to which the latter interest is generally awarded when it is not possible to establish lost profits with a reasonable degree of certainty. The decision maker may instead adopt the simpler solution that can be derived from the international instruments, under which the loss consists of the accrued losses (*damnum emergens*), and the lost profits (*lucrum cessans*), while taking into account any gain resulting to the aggrieved party from the non-performance, and damages can be rejected whenever the existence of loss cannot be established with reasonable certainty.

The determination of the reasonableness of the expectations of the aggrieved party under the principle of full compensation and, thus, the amount of recoverable damages appear, in the first instance, as an issue of contextual interpretation and supplementation of the articulated rules in the particular circumstances of the case. The decision maker is required to examine specific and residual contractual rights, obligations and risk allocations, and, on that basis, determine the causal connections, i.e. whether or to what extent the loss allegedly incurred by the aggrieved party was caused by the non-performance and the events attributable to the risk sphere of the non-performing party, and whether or to what extent such loss was caused by the failure of the aggrieved party to perform its obligations and the events attributable to the risk sphere of the aggrieved party. In these determinations, the decision maker will evaluate the available evidence, by resorting, if necessary, to the test of reasonable persons of the same kind as the parties placed under the same circumstances, and award damages in accordance with the established rule of certainty of damages. Thus, the damages will be awarded only for the loss, which can be considered as being directly caused by the non-performance and the events attributable to the risk sphere of the non-performing party, provided that the existence of the loss and its causal connections can be established with a reasonable degree of certainty.

Even if the share of the non-performance and the events attributable to the risk sphere of the non-performing party in the alleged loss cannot be determined with mathematical precision, the concern for accuracy under *lex mercatoria* requires a discretionary assessment of the respective weight of all causes and, if necessary, a subsequent reduction in the amount of the alleged loss, rather than all-or-nothing solutions. This discretionary power can be derived from the applicable default rules or from the established rule of certainty of damages, and it is an exercise of equity *infra legem*, which is recognized by most of the national legal systems with regard to the assessment of damages. Under the rule of certainty, the decision maker will have the discretion to set the amount of damages on the basis of estimates, approximations and equitable considerations, since the requirement of reasonable certainty will generally not be sought for the extent of loss, as long as the existence of loss is sufficiently certain. The contextual approach of causation and discretionary assessment under the rule of certainty may precede, as a matter of interpretation of contract and its supplementation with individualized terms, the approach of national legal systems, which mainly apply the principle of causation as a means for either establishing liability for non-performance or excusing the party from the liability for non-performance.

Under *lex mercatoria*, the inevitable persistence of estimates, approximations and equitable considerations in the assessment of the damages should not be readily considered as prescribing a decision of “splitting the difference” between the parties, since such a decision implies a process of conciliatory decision making and an underlying intention on the part of the decision maker to satisfy both of the parties by giving something to both parties. The decision maker applying *lex mercatoria* should render an award of damages, which clearly shows that the rationale underlying the award is the accuracy and the exercise of equity *infra legem*, and not compromise in the sense of equity *contra legem*. Thus, the decision maker should articulate in the final award, as explicit as possible, his abstract reasoning, which has been exercised in applying the articulated or established rules and evaluating the available evidence, and which has influenced his estimates, approximations and equitable considerations, as well as the final sum awarded as recoverable damages. In particular, the decision maker should expressly mention those limitations to the amount of recoverable damages, which arise from the causal connections between the loss and the relevant events, articulated rules and established rules in the particular case, in order to enable the parties to

comment and cooperate in the utilization of the knowledge of the particular circumstances of time and place. To the extent the decision maker succeeds in this endeavor, it can be argued that the application of *lex mercatoria* may alleviate the misperceptions in relation to the institution of arbitration as a mechanism of compromise and uncertainty, and create an understanding that it is the means of maximizing the possibility of correspondence of expectations in the order of international commerce through the accuracy of *ex post* decisions.

In the modern *lex mercatoria* doctrine, many aspects of these selected issues of substantive application of *lex mercatoria* are considered as subject to emerging or existing autonomous rules in the order of international commerce. It is argued that the duty of cooperation represents an emerging general principle of law, and the needs of international commerce impose cooperation in good faith upon the parties whose scope exceeds that normally required by national legal systems in relation to their internal orders. The “best efforts” clauses in international contracts are considered as the common denominator between the opposing national legal systems and smoothing away the opposition between strict and fault-based liability in contract law. It is suggested that the theory of *lex mercatoria* was initially formulated around the concept of *force majeure*, whereby the international merchants have developed private solutions, better articulated than those offered by national legal systems, and the repeated use of certain analytical criteria in arbitral awards dealing with *force majeure* recognize a standard of behavior for international merchants, which is conducive to establishing authoritative customary rules of *lex mercatoria*. As to hardship, it is submitted that the interrelated doctrines of *pacta sunt servanda* and *rebus sic stantibus* are often relevant to the international arbitration, where the *clausula rebus sic stantibus* is usually considered as a rule of *lex mercatoria*. It is argued that arbitrators treat a party’s right to terminate the contract for other party’s failure to perform or lack of proper performance as a general principle of law. In relation to damages for non-performance, it is maintained that, the arbitral tribunals recognize the principles of full compensation, foreseeability and mitigation of loss, and the recoverability of lost profits as general principles of law with an international scope.

Although some of those arguments have been verified by the dissertation as indicating the established rules in the order of international commerce, or relevant to the abstract reasoning of the decision maker, they should not be treated as constituting an autonomous body of rules under the concept of *lex mercatoria* in the sense of a method of substantive decision making or a legal system, capable of resolving any contractual disputes in the order of international commerce. The claim that such autonomous rules directly and decisively govern the substance of the contractual disputes overlooks the scope of the parties’ delegation to the decision maker of controlling legal uncertainty within the complex and spontaneous order of international commerce, and motivates an *ex post* decision making process on the basis of equity *contra legem*, to the extent it disregards national laws when they constitute a part of the bargain underlying the contract or indicate the reasonable expectations of the parties. The decision maker applying *lex mercatoria* has to ensure that whenever he exercises his abstract reasoning, such an exercise is capable of revealing itself as an instance of equity *infra legem* or *praeter legem* within the context of articulated and established rules in the particular case. This exercise of abstract reasoning defines *lex mercatoria*, as the law of principled adjudication, which is based on the idea of meaningful utilization of the knowledge of particular circumstances of time and place, and characterized by a contextual approach. The contextual approach under *lex mercatoria* is ultimately capable of determining, within the decision maker’s capacity of controlling legal uncertainty, the law applicable to the substance of the dispute, the interpretation, supplementation or correction of the contract and the applicable default rules and, more specifically, the parties’ duties of cooperation, the

conditions of liability for non-performance, the gaps in the risk allocations whereby the liability is excused due to force majeure and hardship, the conditions, process and consequences of termination, and the recoverable amount of damages for non-performance.

The ultimate purpose of the decision maker applying *lex mercatoria* should be to determine the specific allocations of contractual rights, obligations, and risks under the articulated rules, which consists of terms of the contract and default rules chosen by the parties, pursuant to its basic principles of freedom of contract and sanctity of contracts, and to discover the established rules, which can be in the form of conflict of laws rules, default rules or mandatory rules, for the allocation of residual contractual rights, obligations and risks, pursuant to the basic principle of good faith and fair dealing. In international arbitration, where no national law constitutes the *lex fori* of the arbitral tribunal insofar as its decisions are not made on behalf of a national legal system, this understanding of *lex mercatoria* may serve as *lex fori*. *Lex mercatoria* will not be relevant in this sense only to those cases where the arbitral tribunal, either on its own motion or as required by the parties, actively rejects to apply *lex mercatoria* as the law of principled adjudication and to assume the task of controlling legal uncertainty, by referring to the conflict of laws of the seat of arbitration in order to determine, ascertain and supplement the applicable national law, and applying the national law in the manner a national court would apply, without the increased concern for the reasonable expectations of the parties to a particular case. As this is an unlikely case in the context of international arbitration, the application of *lex mercatoria*, as the law of principled adjudication, can be considered as more common in arbitral practice than the modern *lex mercatoria* doctrine suggests, even if the arbitrators do not consider themselves as applying it in most of the cases, when dealing with the issues of conflict of laws and substance.

Lex mercatoria should not be considered as aggravating the problems of uncertain, arbitrary or capricious decision making in the context of international arbitration, since it is possible for the arbitrators to apply any law arbitrarily or capriciously without ever thinking or mentioning *lex mercatoria* or similar concepts insofar as any law is inherently incomplete and, in most of the cases, there is no competent authority to correct the wrongful application of any law by an arbitral tribunal. The dissertation has suggested that *lex mercatoria* in international arbitration can be understood as an opportunity of remedying those problems through principled decision making and by taking the reasonable expectations of the parties to the center of the dispute resolution process, as required in the order of international commerce. Under such an understanding, control mechanisms of various organizations may focus on the manifest disregard of the reasonable expectations of the parties by ensuring the integrity of proceedings in the light of the basic procedural principles and by safeguarding the relevant public policy contents, rather than allowing the re-litigation of the entire dispute and examining the content of an arbitral award, which is motivated under *lex mercatoria* by a concern for accuracy in resolving a particular dispute in a manner that maximizes the possibility of correspondence of expectations among the elements in the spontaneous and complex order of international commerce.

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